EMERGING ECONOMIES TRANSITION

Reforming Public Pensions

SHARING THE EXPERIENCES OF TRANSITION AND OECD COUNTRIES



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FOREWORD

Over recent decades there has been increasing recognition that the ageing of the population will have significant implications for fiscal, economic and social policies world-wide. In Europe, as the baby-boom generation reaches retirement age in the coming years, the proportion of the population in the labour force is expected to fall. If this were to occur, there would be fewer people producing goods and services to support the population that would include many more retired people. As a result, in the absence of offsetting changes, public pension expenditures are projected to rise significantly. These trends are common to virtually all European countries, including those in the OECD and non-OECD transition countries of Central and Eastern Europe. The economies of Central and Eastern Europe have faced additional challenges, however, arising from their transition to market economies. Many countries of Central and Eastern Europe have reformed some of the parameters of their public pay-as-you-go (PAYG) system. In addition, some have opted for "radical" reforms to enhance the role of private, so-called "second-pillar" pensions. These include Hungary (from 1998), Poland (1999), Latvia (2001) Estonia (2002) and the Russian Federation (2002). Even in those countries that have not adopted these reforms, there has been intensive discussion of alternative approaches. Because some of these countries are quite advanced in reforms of their retirement income arrangements, there are useful lessons for other OECD countries as well.

Under a grant from the Ministry of Foreign Affairs of the Netherlands, the OECD's Directorate of Employment, Labour and Social Affairs organised a seminar on "Practical Lessons in Pension Reform: Sharing the Experience of OECD and Transition Countries". Additional support was also provided under the Russia Programme of the OECD's Centre for Co-operation with Non-Members (CCNM). The Ministry of Labour and Social Policy of Poland hosted the meeting in Warsaw on 27 and 28 May 2002. The Ministry was supported in this by Amplico Life.

This publication includes the written papers presented at the Seminar. These papers deal with a number of complementary themes: *a)* the political economy of pension reform; *b)* the processes of reform and the constraints affecting policy choices; *c)* the living standards of pensioners and the distributive impact of reforms; and *d)* practical issues in the implementation of reforms. The main papers discuss these issues comparatively, while all four aspects are illustrated by contributions detailing concrete country experiences in pension reform. The papers present the analyses of a very wide range of policy makers and experts coming from eleven OECD member countries, including the four CEE-OECD countries, and five non-member countries (Russia, Slovenia, Latvia, Lithuania and Estonia).

This study is published on the responsibility of the Secretary-General of the OECD.

Eric Burgeat
Director
OECD's Centre for Co-operation
with Non-Members

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INTRODUCTION

LEARNING FROM PENSION REFORM EXPERIENCES

by
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Background – the reasons for pension reform

Over recent decades, there has been increasing recognition that population ageing will have significant implications for fiscal, economic and social policies in Europe. Demographic trends over the past few decades have meant that the share of the working-age population has increased, but these trends could start to reverse in five to ten years time. The baby-boom generation will reach retirement age, and the proportion of the population in the labour force could begin to fall. The result is that there would be fewer people producing goods and services, to support the population that includes many more retired people (OECD, 2000). As a result, in the absence of offsetting changes, public pension expenditures are projected to rise significantly. For the 15 countries of the European Union, pension spending is forecast to rise from an average of 10.4% of GDP in 2000, to a peak of around 13.6% of GDP in 2040 (EPC, 2001).[2]

These trends are common to virtually all European countries, including those in the OECD and in the European Union, as well as to the OECD and non-OECD transition countries of Central and Eastern Europe (CEE). The economies of Central and Eastern Europe have faced additional challenges, however. Many of these countries had close to universal coverage of retirement pensions in the 1980s. Economic transition, in particular, privatisation and enterprise restructuring, resulted in large increases in open unemployment, and falls in employment to population ratios. One reaction to

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1. Many people must be thanked for their assistance and support during this project. The financing of the project came from a grant (Project No. QE024201) from the Ministry of Foreign Affairs of the Netherlands. I am grateful to Monique Van Wortel, then of the Delegation of the Netherlands to the OECD for her support, and also to Huib de Bliek of the Ministry of Foreign Affairs. Additional support was also provided under the Russia Programme of the OECD's Centre for Co-operation with Non-Members (CCNM). The Ministry of Labour and Social Policy of Poland hosted the meeting in Warsaw on 27 and 28 May 2002. The Ministry was supported in this by Amplico Life. Tibor Parniczky helped considerably in identifying contributors. I am grateful to David Lindeman, Michael Förster and Jean-Pierre Garson for helpful suggestions and comments. In organising the conference, assistance was provided by Pauline Allison and Patricia Comte. The proceedings were edited by Alexandra Heron.

2. Holzmann, Mackellar and Rutkowski (2003) argue that these projections are over-optimistic, as they assume lower benefits and higher employment than currently.

this was to allow for early retirement, or for increased access to disability programmes. The increase in the number of pensioners reduced the financial viability of public pension systems, as system dependency ratios deteriorated. The number of contributors, and the amount of income reported, fell because of evasion. The first five or six years of transition also saw significant declines in GDP per capita in many countries, and widening income inequality in a number. In addition, fertility rates declined significantly in many CEE countries, making long-term demographic projections even more unfavourable.

As a result, the pressures for reform have been even stronger in many countries of Central and Eastern Europe, than the European Union, and other non-European member countries of the OECD. Table 1 provides a range of comparative indicators of features of EU and CEE pension systems. In summary, these show that, on average, public age pension spending in the CEE countries increased, from just under the EU average in 1990, to just over the average by 1998, but that the proportion of the population aged 65 years and over, remains higher in the EU countries. Despite similar levels of aggregate spending, contribution rates for retirement pensions (and, for all, social insurance contributions) are significantly higher – 25% on average – in CEE countries. This appears to be because the ratio of contributors to the labour force is significantly lower in CEE countries – around 75%, compared to 89%. Correspondingly, the ratio of pensioners to contributors is higher in the CEE countries, with just over six CEE pensioners for every ten contributors, compared to just under five pensioners per ten contributors in the EU countries. It is also worth noting that there are considerable differences within each of these groups of countries.

Longer term projections are even more unfavourable for many of the CEE countries. In the absence of changes to the system, and with projected increases in life expectancy, public pension spending in Latvia, for example, was projected to increase to 16.6% of GDP by 2050. The system dependency ratio was projected to increase by 50% in Lithuania by 2030, and by 65% in the Slovak Republic. These developments have produced pressures for reform in all CEE countries. Although the range of reforms adopted has differed, the underlying motivations for reform have similarities. For example, as noted by Katharina Müller in Chapter 1 in this volume "The need for fundamental reforms in Hungarian old-age security was widely acknowledged, as the inherited pay-as-you-go (PAYG) system was seen as inequitable, inadequate and unsustainable".

Principles for reform

Given these challenges, how can retirement income systems be made more sustainable, adequate and equitable? Previous OECD work has identified a number of principles for reform (OECD, 1998; 2000). These include that public pension systems, taxation systems, and social transfers should be reformed to remove financial incentives to early retirement, and remove financial disincentives to later retirement. A variety of reforms are needed, to ensure that more job opportunities are available for older workers, and that they are equipped with the necessary skill and competence to use them. Retirement income should be provided by a mix of tax and transfer systems, advance-funded systems, private savings, and earnings. The objective is risk-diversification,[3] a better balance of burden-sharing

3. An example of an existing diversified pension system is that in the Netherlands, which is assessed in Chapter 11 by Peter Stein in this volume. The Dutch system of retirement incomes has three pillars, including the state pension, which guarantees every resident a basic universal pension from the age of 65, with benefits index-linked to the average development of collective labour agreements on wages. The second pillar consists of the occupational pensions that supplement the state pension, and for whom the social partners, employers and employees, are primarily responsible. The last, and comparatively the smallest pillar, are the individual personal pensions. In 2000 almost 50% of the income of the elderly came from the basic pension, 40% from supplementary pensions, and 10% from the third pillar.

between generations, and to give individuals more flexibility over retirement decisions. It is also important that the development of advance-funded pension systems should go hand-in-hand with that of financial market infrastructure, including the establishment of a modern, and effective, regulatory framework.

Pension reform can be controversial, as recent protests against reform proposals in a number of EU countries demonstrate. Advocates of pension reform themselves also differ, in relation to their preferred pension prescriptions. Holzmann, Mackellar and Rutkowski (2003) distinguish between "parametric" changes to social insurance systems (altering retirement ages or replacement rates, but leaving the basic structure of the system unchanged), and "paradigmatic changes", more radical shifts to private and advance-funded second pillars. Holzmann, Mackellar and Rutkowski (2003, p. 9) also point out that these more radical reforms are based on a number of policy arguments, including that individual accounts have desirable work and compliance incentives; funding can increase a nation's savings and investment under the right fiscal conditions; and funded accounts can accelerate the development of capital market institutions and efficiency in capital allocation, therefore leading to higher growth. They also note that these assumptions are more attractive in CEE countries, where the objective is to catch up with the EU.

Chapter 6 by Nicholas Barr argues, however, that there are a number of myths about the effectiveness of funding of pensions, in resolving the challenges posed by demographic ageing. The chapter argues that in the face of demographic pressures, the key variable is output. This means that countries should consider the full menu of policies that promote output growth, and the argument that funding insulates pensioners from demographic change should not be overstated. Nicholas Barr also discusses the pre-requisites for successful pension reform, arguing that the starting point is that state pension promises should be fiscally sustainable. In addition, there should be sufficient political support for a reform programme, the state should have the administrative capacity to enforce taxes and contributions, to maintain economic stability and to provide effective regulatory capacity. Further, private sector pre-requisites for reform include a sufficiently well-informed population, the existence of financial assets for funds to hold and financial markets to channel investments, and adequate private sector capacity. The final part of Barr's chapter turns to the range of choices facing policymakers, drawing on the very different arrangements in different countries. The main conclusions are threefold: the key variable is effective government. From an economic perspective, the difference between pay-as-you-go and funding is second order. The range of potential choice over pension design is wide. One size does not fit all.

In this context, a number of the other contributors in this volume identify a range of reasons underlying the success, or otherwise, of the actual reform programmes implemented in CEE countries. From a political economy perspective, radical reform proposals have had the greatest likelihood of success, where a "bundling" strategy was pursued – most of the politically sensitive parametric reforms were introduced simultaneously with the introduction of individual accounts. On the other hand, concern about the fiscal costs of transition has played a role in the failure of some countries to proceed with the introduction of funded systems, including Lithuania and Slovenia. These issues are explored in depth in Chapter 1 by Katharina Müller, who seeks to explain the observable pension reform outcomes in six transition countries, as a result of the interplay of economic and political variables. The two earliest Central European cases, Hungary and Poland, are contrasted with two more recent cases of pension privatisation, Croatia and Bulgaria. The cases of the Czech Republic and Slovenia are presented, where policymakers did not opt for the radical changes advocated by the "new pension orthodoxy". The chapter describes and explains how different pension reform choices came to be made in these countries, by analysing the behaviour of individual and collective actors under economic, political and institutional constraints. The cases analysed indicate that, contrary to

conventional wisdom in social policy research, far-reaching pension reform is possible in a democratic context.

An often overlooked aspect of pension reform is achieving effective administration and delivery of benefits, as well as collection of contributions. Chapter 18 by Warren McGillivray notes that however well-conceived a contributory national pension programme may be, however sound the economic principles on which it is founded, irrespective of whether it is based on defined benefits or defined contributions or whether it is publicly or privately managed, if participants fail to meet their contribution obligations, the pension scheme cannot achieve the objective of providing adequate retirement income for them and their dependants. Contribution evasion has obvious implications for individuals. But it also has implications for the state, which may be importuned to supplement inadequate pensions from general revenues. The nature of contribution evasion, and why contributions are evaded, are surveyed. Possible practical measures that have been applied to promote compliance are described, and the dangers of contribution evasion to participants, and to the state, are outlined.

What types of reforms have been adopted?

EU and CEE countries have adopted a wide range of reform strategies. In general, there have been at least two stages to reform strategies in Central and Eastern Europe. The first, in the early 1990s, involved the transformation of the inherited systems based on the Soviet model, towards the social insurance models common in the European Union. Generally, the second stage involved reforms to address the escalating costs of social insurance (associated with increasing unemployment and lower labour force participation, and high levels of inflation). These second-stage reforms either involved "parametric" changes to social insurance systems, or "paradigmatic changes". In some countries, the second stage involved parametric reforms, and the paradigmatic changes were a third phase of reform.

Table 2 provides an outline of some of the major strategies adopted over the 1990s. This listing is not comprehensive, but is intended to give an indication of the wide variety of reforms. All of the countries included have reformed some of the parameters of their public PAYG systems. In addition, some have opted for "radical" reforms, to enhance the role of private, second pillar pensions. These include Hungary (from 1998), Poland (1999), Latvia (2001), Estonia (2002) and the Russian Federation (2002). Even in those countries that have not adopted these reforms, there has been intensive discussion of alternative approaches. It is apparent that nearly all of the countries have addressed the issue of retirement age, although to varying extents. Changes in relation to replacement rates have shown rather divergent trends. On the one hand, Hungary and Slovenia have taken steps to reduce replacement rates. On the other, some countries such as the Czech Republic, Latvia and the Slovak Republic have taken steps to protect the real purchasing power of benefits. An important initiative has involved the introduction of minimum pensions, or state pensions, of different forms – as in the case of Estonia, Latvia, Russia and Slovenia.

Virtually all of the CEE countries have also taken steps to introduce regulations of voluntary private pensions. This took place in the early 1990s in Hungary, Russia and Slovenia, and later in the decade in Estonia, Latvia and Lithuania. Systemic reforms mandating the introduction of advance-funded second pillars started to come into operation towards the end of the 1990s, or early in the current century. As a result, it is only possible to assess the early stages of these reforms. Latvia, Poland and Russia have combined notional defined contribution (NDC) first pillars with mandatory second pillars. In broad terms, only a relatively small share of payroll is being diverted to the second pillar, around 6 or 7% in most countries. The exceptions are Latvia, where the share of payroll starts at 2%, and will rise to 9%, over time. Russia requires younger workers to divert a lower share than those over 35.

It is forecast that the proportion of the labour force in the funded pillar, by 2003, will range from around 45% in Hungary to 70%, or a little more, in Latvia and Poland. By 2020, it is projected that pension fund assets will be between one-fifth and one-third of GDP in the countries introducing these reforms. While the strategies for introducing these systems differ, they generally involve making contributions mandatory. either for new entrants to the labour force. or for younger workers. In Estonia, it will be voluntary, but those who opt out will pay higher contributions.

Turning to the details given in the chapters in this volume, it will be readily apparent that a diverse range of reform approaches have been adopted. Two of the chapters look at parametric reforms in two current EU countries. Chapter 4 by Markus Sailer notes, however, that the pension reform enacted in 2001 is considered as a major structural change in the German pension system. The core element of the reform is a (partial) shift from PAYG funded social security pensions to pre-funded occupational and private pension plans. The chapter argues that the existing German system of pension provision should be described as a multi-pillar system: The first pillar is highly stratified, and comprises the statutory pension insurance for workers, miners and employees, the pension provision scheme for civil servants, the pension provision scheme for farmers, and professional pension schemes for liberal professions like lawyers, medical doctors, architects, etc. Occupational schemes cover about 50% of the labour force. Before the 2001 reform, about 70 to 80% of the pensions paid from all schemes were financed on a PAYG basis, 20 to 30% being fully funded. The focus of the pension reform of 2001 was on the statutory pension insurance for workers, miners and employees, and related adjustments in occupational and private schemes. As a result of the reform, the replacement rate under the social insurance pension scheme will gradually decline from 70% to 64%, until 2010. To make up for the long-term shortfall of provision, new schemes of voluntary supplementary pension provision have been established. The new supplementary pension provision schemes were implemented from 2002 onwards, either through occupational pension provision, or private pension plans. These changes should limit short-term increases in the contribution rate. The pension reform entitled every employee to request occupational pension provision, from his or her employer. The introduction of pension funds, as an additional instrument for occupational pension saving, was seen as a significant step to boost the attractiveness of occupational pension schemes.

Mauro Marè and Giuseppe Pennisi, in Chapter 10 on the pension reform process in Italy, point out that reforms in 1992-93 did not change the basic design of the PAYG pension scheme, but aimed to improve financial sustainability. The 1995 reform aimed at stabilising the level of pension expenditure to GDP, at increasing the efficiency of the labour market, by reducing its distortions, and the “tax on labour”, and at making the overall pension system more equitable. Both reforms, by and large, were based on moving from a one pillar pay-as-you-go-system to a two or three pillar system, with an increasing role, and a fully funded scheme. However, the transition will be very gradual, and the reformed system will produce benefits only in the long run; it is estimated that only in 2070, will the new system be fully in effect. These authors therefore discuss several possible routes for further reform, to make the pension system more equitable, and more effective, in targeting to low income groups. These include: i) to improve the actuarial mechanism; ii) to move to a mixed pension; iii) to give more flexibility to individuals in the choice of their pensionable age; and iv) to introduce a fully-funded pension system, run by the government. As for lessons to be learned, the chapter suggests that periods of crisis can sometimes provide opportunities to undertake bolder institutional reforms, if properly “nurtured” towards reform, as well as towards higher quality institutions in the social policy area. The Italian experience also shows that pension reforms can come to a standstill, if they are not included in broader welfare-state, and labour-market institutional reforms.

A number of CEE countries have also introduced parametric reforms. Chapter 2 by Audronė Morkūnienė describes in detail the pension reform process during the 1990s in Lithuania, and summarises the arguments of some of the key players. Following the introduction of a separate social

insurance budget in 1991, a pension reform package was enacted in 1995, mainly consisting of a new pension formula, an increase in the retirement age, and abolition of early retirement privileges. Negotiations over the establishment of pension funds in Lithuania lasted until 1999, when eventually a special law regulating pension funds was adopted. Although in force since 2000, no single pension fund had been set up in Lithuania by 2002. Reasons include rigid regulation, the small Lithuanian market, and an unfavourable tax regime. As a consequence, there are almost no prospects to sell pension funds products, while the life insurance market is growing rapidly. Since 1999, the introduction of a mandatory fully-funded second pillar has also been under debate. Although a Pension Reform Concept has been adopted by Parliament, and an Action Plan was prepared in 2000, on the basis of the White Paper on Pension Reform, the reform proposals have been altered and partly postponed, by three subsequent governments, since 1999. In particular, the mandatory versus voluntary character is still under discussion. In addition, the pension reform proposal actually competes with the so-called savings restitution programme, particularly in relation to the issue of financing the transition costs (estimated at around 1% of GDP). The general elections in 2004 might well put the issue of radical pension reform again on the agenda.

The Slovak pension system is another, where (until very recently), reforms have been parametric, rather than paradigmatic. Chapter 3 by Marek Jakoby describes and assesses the pension system in the Slovak Republic, which is PAYG financed, supplemented by state budget financing. Expenditure for public pension benefits increased significantly between 1995 and 2000, influenced mainly by unfavourable demographic developments, particularly, the increase in the number of people over labour force age, and the rise in their share in the total population, increases in pensions, and worsening developments in socio-economic factors, mainly the rate of unemployment and the net income of households. Projected demographic developments, in general, low retirement ages and anticipated increases in currently low average old-age pensions, are significant risks for public pension expenditure, in the future. Private pension schemes have also not yet been well developed in the Slovak Republic. The chapter therefore argues that the current pension system in Slovakia requires a systemic change – mainly through shifting the weight onto capital financing, and individual accounts, with an emphasis on creating conditions conducive to a more marked use of voluntary, complementary and individual private pension insurance schemes.

Dušan Kidrič's chapter (Chapter 9) discusses the process of preparing for pension reform in Slovenia. A new Pension and Disability Insurance Act was passed in December 1999, and came into force on 1 January 2000. The model adopted is a combination of a modernised PAYG, defined benefit model, and voluntary, supplementary, (pre) funded pension insurance, which can be provided by existing, or special new financial intermediaries. In the pay-as-you-go financed component, the reform has introduced new rules for the existing types of pension, and has introduced new pensions. The retirement age has been raised; new rules encourage later retirement; work after meeting the retirement criteria is especially rewarded; and pensions are reduced, in cases of early retirement. A completely new entitlement, introduced by the reform, is the State Pension, which will gradually be granted to citizens of the Republic of Slovenia aged over 65, with no other income or wealth. Supplementary pension insurance is now provided for separately, as part of the Pension and Invalidity Insurance Act. Collectively agreed supplementary insurance, paid for by the employer, is the main base for the second pension. The present development of supplementary insurance indicates that this will be the prevailing form of supplementary pension provision.

Chapter 17 by Jiri Kral describes the development and current situation in pension reform in the Czech Republic, and discusses the supplementary pension scheme, as well as the newly prepared occupational pensions scheme, and private insurance. Pension entitlements in the Czech Republic before 1989 were, in principle, very generous. In order to resolve shortcomings of the system, several reforms have been enacted since, including the removal of discrimination against the self-employed

(1990-92); the separation of contributions from taxes (1993); supplementary pension insurance (1994); changes in qualifying periods and the retirement age (1995); special pension insurance accounts (1996); and the state contribution act related to security of supplementary pensions (1999). Currently, the law for a supplementary occupational pension has been prepared, but can be enacted only after the next elections (June 2002). The objective of the introduction of this scheme is not to substitute the existing systems (private pension open funds system with a state contribution, life insurance), but to complement the range of pension fund schemes with those of the closed-end occupational pension funds. New laws on occupational pensions have been prepared, and are under discussion. The government's pension concept relies on a mandatory pay-as-you-go system, guaranteed by the state, and on voluntary, private, supplementary, fully funded schemes. Alternative ideas, such as a low flat-rate pension, and voluntary savings on top, or a mandatory, private, savings scheme as a second pillar, have been proposed by other political parties. A broad political and expert consensus is, however, the most important condition for further development of the scheme.

While Hungary has opted for radical pension reform, the chapter by Agnes Matits (Chapter 16) focuses on Hungarian experience in developing new institutions to provide private pensions supplementing, and complementing government social security pensions. As noted above, Hungary now has a three pillar pension system, with the first pillar being provided by public social security provisions. The second pillar consists of pensions paid by mandatory private pension funds, that are built up from mandatory contributions, set as a proportion of wages. The third pillar includes pensions that are provided on the basis of pension fund contributions, or insurance fees paid voluntarily by the insured person or his/her employer. In Hungary it has been possible to found, and operate, pension funds since 1993, while the 1998 pension reform established mandatory private pension funds. At the time of formation of the pension fund sphere, a relatively large number of mainly small pension funds were founded. However, of the almost 300 voluntary pension funds established fewer than 150 funds remained by mid 2000, and fewer than 110 by the beginning of 2002. According to more realistic estimates, it is expected that besides the 4-6 dominant pension funds covering 85-90% of the market, a maximum of 10-12 mandatory private pension funds and about 70-80 voluntary funds will eventually remain. High levels of concentration can be observed in both the mandatory private pension fund and the voluntary fund market. Concentration is especially high in the mandatory fund market, where, according to data for the end of 2001, of the nearly 2.25 million fund members about 90% belong to the largest six funds. Membership of each of these funds has reached 100 000 persons, and these six funds possess assets that represent about 80% of all mandatory pension fund assets. Funds with a bank or insurance company background obtained an almost overwhelming advantage in preparing information, and in getting this to potential fund members. The chapter argues that the economic inevitability of today's level of concentration would be justified, if pension funds organised on market principles, and those organised on non-market principles, had started with equal chances.

More large-scale paradigmatic reforms have been undertaken in Latvia and Poland. The chapter by Inta Vanovska (Chapter 8) describes the pension reform to a three pillar system in Latvia, and discusses its challenges, outcomes and performances. Latvia faced the heritage of a generous, but financially unstable, pension system, which discouraged work effort, and payment of taxes. In order to solve these problems, Latvia opted for a radical shift in pension protection. Pension reform has now been completed, with the introduction of notional defined contribution pension scheme (NDC PAYG, first pillar) in 1996, a state mandatory fully advance-funded pension scheme (second pillar) in 2001, and private pension funds (third pillar), in 1998. The main goal of these reforms was to reverse the upward trend in pension expenditures, and create a sustainable multi-pillar system, that corresponds to market principles, and is affordable for coming generations. Two main lessons emerge from the Latvian experience. First, as the NDC scheme is free from redistribution elements and exemptions, and therefore less oriented to social cohesion, the radical shift to the public pension scheme requires, at the same time, significant and financially expensive improvements in the safety net for people in old

age, plus a growing economy. Second, in introducing a fully advance-funded mandatory pension scheme, as the integral part of the public pension system, the state has to take full responsibility to make this scheme function well.

In Chapter 15, Agnieszka Chlon-Dominczak discusses the new pension system introduced in Poland, in 1999. The need for pension reform resulted from high pension expenditures in Poland, that peaked in 1995, exceeding 15% of GDP, combined with projected ageing of the Polish population. The main goal of pension reform in Poland was to create a system that is financially stable, in the long run. The previous pension system offered relatively high old-age pensions, with average replacement rate, at around 70%. The reform, due to changes in eligibility criteria, and the pension formula, will have a significant impact on the overall situation of the pension system. Replacement rates, from pensions granted under the new pension formula, will be lower than in the old system, resulting in a reduction in expenditure. The new system also abolishes all early retirement privileges. It is projected that, by 2005, the total deficit in the public old-age pension scheme will be lower than the amount of contributions transferred to pension funds.

Adequacy and the distributional outcomes of pension reform

One of the most important issues in pension reform is the distributional consequences of reform proposals. Adequacy and equity can be regarded as equally important objectives of reforms to pension systems, as sustainability. While it is not possible to be conclusive about trends in all countries, there are a number of general conclusions that do apply to those for whom data has been analysed. In some senses, the results have been rather paradoxical. Pension reforms have concentrated on stabilising or reducing expenditure, with little explicit attention given to the economic well-being of older people. While the real value of pensions has tended to fall, the distribution of pensions has become more compressed in many CEE countries. This compression may have protected the situation of some of the poorest pensioners, but it has also been the source of tensions and pressures, as the results have not been perceived as fair (for example, in the Slovak Republic). But partly as a result, pensioner households, on average, have improved their relative economic position – this appears to be the case in Hungary, Poland, Russia and Slovenia. However, this also reflects the fact that other, vulnerable household types, such as the unemployed, and those with children, have fared even worse than pensioners. Nevertheless, major poverty problems remain, for significant groups of older people, particularly the very elderly, and those living alone in Russia, and single female pensioner households, in a number of other countries. It has been argued that these vulnerable groups among older people are also not well-served by some aspects of the systemic pension reforms. As with other distributional issues, gender issues have not been a primary focus of reforms. While formal equal treatment of men and women has been advanced by some reforms, future problems may emerge because of the gender wage gap, and the disproportionate role of women in unpaid caring. NDC schemes raise the prospect of increased poverty among elderly women, in the future. Particular attention needs to be given to the variety of schemes for guaranteeing minimum incomes in retirement, in relation to their effectiveness, their potential budgetary costs, and their implications for incentives.

In relation to experiences in OECD member countries, Scherer (2002) analyses the relation between public pension, and other income sources, in the incomes of retired people, and the interaction between these issues and household composition in nine OECD member countries: Canada, Finland, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom and the United States. The study concluded that public pensions, particularly those received by people at the upper end of the income distribution, are substitutes for other resources, and that there is not an obvious difference between countries, in the level of resources conferred by different types of financing arrangements. The study emphasizes the crucial role, in all countries, of public transfers for those with low incomes, but the much greater variety for other income groups. The importance of

other resources – particularly owner-occupied housing – is also illustrated. This shows that a more differentiated approach to pension reform may be warranted. Rather than trying to introduce capitalised funding as a significant component of retirement incomes for the whole population, a more realistic approach may be to concentrate on those who are well able to broaden the ways in which they provide for their retirement, encouraging this through financial incentives. At the same time, the current incentives to retire early, which are also increasingly affecting this group, need to be reversed.

Chapter 12 by Tine Stanovnik describes the motives for pension reform, reviews the macro-economic background, and compares the economic well-being of the elderly in selected Central and Eastern European countries. Generally, pension reforms have endeavoured to decrease the redistributive role of the pension system, and although not neglected, the economic well-being of the elderly was not the prime concern of the reforms. Against an unfavourable macro-economic background, most countries in transition took measures to stabilise, or even decrease, pension expenditures. This was done in a very pragmatic way, through various forms of indexation, which, in effect, decreased the real value of pensions and, incidentally, significantly compressed the distribution of pensions. The combination of negative growth and increased inequality lead to an increase in overall poverty, in particular, in the Baltic States, the countries of South Eastern Europe, and Poland. Past, and recent, comparative studies seem to indicate that pensioner households have actually improved their relative income position during the transition. The elderly have a lower poverty risk than other vulnerable groups – such as the unemployed or children – and a lower risk than the total population, on average, in a number of countries. A more in-depth study of Hungary, Poland and Slovenia reveals some common features: the share of income from earnings decreased; an increasing number of pensioners live in pensioner households (although still less than in developed market economies); and an increasing share of the pension population is now situated in the middle range of the income distribution. In spite of the general improvement in the income position of all types of pensioner households, the income position of a very sizeable group – single female pensioner households – is still precarious. Moreover, gender differences seem to have remained during the transition.

Chapter 13 by Alexander Razumov analyses aspects, and dimensions, of the living standards of different categories of pensioners in the Russian Federation, and considers the causes and factors underlying these differences. It also describes social policy measures aimed at improving pensioner living standards. The elderly constitute some 21% of the total population, and their share is expected to rise further. Two-thirds are women (four-fifths in the age group 85 and over), and single old women are really the specific social problem in the Russian Federation. Among the total of 38 million pensioners, around 6 million persons are involved in income-generating employment, and around 2 million received social pensions. One of the main characteristics of the pension system, in Russia, is that there are various types of privileged and special pensions. During the 1990s, three shocks caused levels of real pensions to decline substantially: price liberalisation in 1992 and the two financial crises, in October 1994, and in August 1998. Throughout all the years of reform, the minimum old-age pension was lower than the amount of the average subsistence minimum of a pensioner. At the same time, the average pension was kept above the subsistence minimum amount of a pensioner, for almost all the years of the transition period, and the ratio of the average pension to the average wage showed, on the whole, a positive trend. The deterioration in the pension indicators was caused by non-payment, and delays in payment of wages, accompanied by contribution payment evasion, and contribution collection arrears. This, in turn, resulted in pension arrears. However, due to economic growth since the second half of 1999, the indicators of the living standards of pensioners seem to have become more favourable. The chapter analyses officially established indicators for poverty (incomes below the subsistence minimum amount), and extreme poverty (less than half the subsistence minimum amount), and finds that pensioners, on the whole, have a lower than average poverty risk in the Russian Federation. Working pensioners, in particular, had the most favourable indicators. At the same time, categories of pensioners, such as handicapped pensioners, recipients of survivor's pension, recipients

of social pension, and recipients of the minimum old age pension, particularly the very elderly, as well as those residing separately, and without relatives, are in the worst position.

A related issue of great importance is how women fare under different pension systems, and as a result of pension reforms. Chapter 14 by Silke Steinhilber presents the results of a study of the relationship between pension reform experiences, and concerns with gender equality in CEE countries.[4] This study looked in detail at the experience of three countries, the Czech Republic, Hungary and Poland. A number of patterns grew out of the country analyses. First, gender equality was a secondary issue in these pension reforms. This limited focus has led to some disadvantages for women, that were not foreseen. While the reforms have advanced formally equal treatment of women and men, this has not been of great significance for women, due to the influence of inequalities in the larger environments, in which the schemes operate. One major thrust of the reforms, a closer linkage between contributions and benefits, is generally detrimental for women, because of the gender wage gap, and the disproportionate role of women in unpaid caring responsibilities. Special problems have arisen for women in privatised pension schemes, with respect to caring credits, and the role of life expectancy in computing private annuities. Projections show that a highly detrimental combination for women's old-age security is: a) a continuing early retirement age for women, and b) a notional defined contribution (NDC) system in the public pension tier, as is the case in Poland. This combination raises the prospect of significantly increased poverty among women pensioners. The outcomes of the study also point at the need for improved awareness of the gender dimensions of reforms among pension experts and decision-makers.

Conclusion

In many respects, it is too early to comment on the success, or otherwise, of the systemic reforms involving the introduction of mandatory, funded second pillars, as these systems will still take many years to mature, and generate outcomes. Results of other reforms have been mixed. The rapid escalation of pension expenditures that marked the first stage of transition appears to have been halted, in most of these countries. The trend to earlier retirement has also slowed, and in the case of Slovenia, there has been a significant increase in employment rates among older workers. These positive trends might not be entirely due to pension reforms, however. Moreover, while formal retirement ages have been increased, they remain relatively low. In addition, contribution rates for pensions remain high, particularly in Poland and the Russian Federation, and the total level of social insurance taxes exceeds 40% of the payroll in all countries, apart from Estonia, Latvia and Lithuania. Overall, this suggests that, while the sustainability of these systems appears to have improved, there is scope for further reform, particularly reforms that can achieve higher effective retirement ages, and result in lower levels of contributions. The pressure to raise the effective age of retirement will become stronger on those CEE countries that are about to join the European Union, given the objective of the EU to raise employment at older ages. It is also clear that pension reform is far from over in Europe. Reform proposals have been put forward in a number of countries, including Austria, France and Germany, while among CEE countries, the Slovak Republic has recently announced its intention to proceed with paradigmatic reforms, towards a multi-pillar system. The chapters in this volume also point to the importance of monitoring distributional issues, in particular, in relation to the adequacy of the entire package retirement incomes. There is a clear need for continuing analysis of the relative income position, and economic well-being, of older people. Such research will not only provide a useful "monitoring" function of pension reforms, but also provide an essential element for social policy decision making.

4. The study was sponsored by the International Labour Organisation Central and Eastern European Team and was undertaken as part of a larger technical co-operation project supported by the French government.

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Table 1. Characteristics of public pension systems EU, other OECD and transition economies, 1990s

	Public pension expenditure		Population 65 and over % of total		Contribution rate/ Gross wage	All social insurance taxes	Contributors labour force	Contributors working age population	Pensioners/ Contributors	Pensioners/ Population	Replacement rates	
	1990	1998	1990	1998	1990s	1990s	1990s	1990s	1990s	1990s	% of average wage	% of GDP per capita
Austria	9.5	9.9	15.0	15.4	22.8	45.0	95.8	76.6	45.8	20.1	37.3	69.3
Belgium	6.5	7.4	15.1	16.5	16.4	38.9	86.2	65.9	58.0	21.5		
Denmark	6.3	6.8	15.6	14.9	-	-	89.6	88.0	42.6	21.3	36.3	46.7
Finland	6.4	7.0	13.4	14.8	21.2	27.9	90.3	83.6	56.0	23.2	48.7	57.4
France	9.2	10.6	14.0	15.8	16.0	51.0	88.4	74.6	48.0	18.6		
Germany	8.5	10.5	15.0	16.6	20.3	42.0	94.2	82.3	51.9	24.0	45.2	62.8
Greece	9.1	10.2	14.0	15.8	20.0	34.5	88.0	73.0	43.0	24.2	33.5	85.6
Ireland	3.7	2.5	11.4	11.3	-	14.4	79.3	64.7	26.7	8.3	35.8	77.9
Italy	11.0	12.8	14.5	17.4	29.6	56.7	87.0	68.0	74.0	28.6		
Luxembourg	5.9	8.0	13.6	14.3	16.0	28.7	-	-	-		32.7	67.9
Netherlands	7.2	6.2	12.8	13.4	32.1	56.0	91.7	75.4	-		40.8	48.5
Portugal	4.2	6.2	13.2	15.2	34.8	37.8	84.3	80.0	57.0	24.1	43.9	44.6
Spain	7.2	8.1	13.4	16.6	28.3	38.3	85.3	61.4	54.8	17.8	41.8	54.1
Sweden	7.2	7.5	17.8	17.8	20.0	24.9	91.1	88.9	48.0	23.4	-	78.0
United Kingdom	5.0	5.3	15.7	15.7	-	13.9	89.7	84.5	40.4	18.0	38.0	-
EU average	*7.1*	*7.9*	*14.3*	*15.4*	*23.1*	*36.4*	*88.6*	*76.2*	*49.7*	*21.0*	*39.5*	*63.0*
Czech Rep.	5.4	6.4	12.5	13.7	27.2	48.5	85.0	67.2	53.0	24.2	48.6	37.0
Hungary	(6.8)	6.4	13.3	14.5	30.5	60.5	77.0	65.0	78.1	27.5	57.9	33.6
Poland	4.5	8.0	10.1	11.8	45.0	48.0	68.0	64.0	53.7	18.2	55.4	61.2
Slovak Rep.	-	5.2	10.4	11.3	26.5	46.0	73.0	72.0	57.0	22.0	42.5	44.5
Estonia	5.3	7.1	11.7	14.0	20.0	33.0	76.0	67.0	60.0	25.0	25.0	56.7
Latvia	7.8	10.8	11.0	12.8	20.0	38.0	60.5	52.3	65.9	25.0	62.8	47.6
Lithuania	-	7.6	11.0	11.1	22.5	24.0			69.2	22.5	(36.0)	21.3
Slovenia	11.7	14.3	11.7	13.1	31.0	45.8	86.0	68.7	58.9	22.2	68.7	49.3
Russian Fed.	6.1	6.2	10.0	12.2	40.8	65.3	-	-	-	25.1	-	18.3
Transition average	*6.8*	*8.0*	*11.3*	*12.7*	*29.3*	*45.5*	*75.1*	*65.2*	*62.0*	*23.5*	*49.6*	*41.1*

Source: Palacios and Pallarès-Miralles (2000); OECD (2001).

Table 2. Reforms to retirement income systems, selected CEE countries, 1990s

	Parametric reforms				Second pillar reforms					
	Retirement age	**Replacement rates/benefit levels**	**Other**	**Voluntary second pillar reforms**	**Reform starting date**	**First pillar**	**Second pillar as share of payroll**	**Projected pension fund assets in 2020 (% of GDP)**	**Workforce in funded pillar in 2003 (%)**	**Switching strategy**
Czech Republic	1990-1992: abolition of preferences; 1995: phased increase in retirement ages for men and women	1990-97: Many pension adjustments for inflation	1993: Premiums introduced separate from taxation system; 1996: introduction of special pension account	1994 : Supplementary pension insurance, with individual contributions	-	PAYG DB	-	-	-	-
Hungary	1996: Gradual increase in retirement age to 62 for men and women; reductions for early retirement and some increase for delays	1991: indexation to net wages (real cuts); move towards benefits based on lifetime earnings; valorisation of past earnings reduced	1992: Independent Pension Insurance Fund	1993: Introduction of voluntary private pension funds	January 1998	PAYG DB	6%	31	45	Mandatory new entrants; voluntary others
Poland	1999: Withdrawal of early retirement privileges in new NDC system, effective from 2009	1991: recalculation (increase) in pensions; 1995: change in indexation (cuts)	-	-	January 1999	NDC	7.2%	33	70	Mandatory <30; voluntary 30-50 others
Slovak Republic	1999: abolition of early retirement	1991: indexation provisions	1999: contributions from working pensioners	1996: regulation of supplementary insurance of employees	2000: Concept of Soc. Ins. Reform approved by Gvt but no implement-ation	PAYG DB	-	-	-	-

Table 2. Reforms to retirement income systems, selected CEE countries, 1990s *(cont'd)*

	Parametric reforms				Second pillar reforms					
	Retirement age	**Replacement rates/benefit levels**	**Other**	**Voluntary second pillar reforms**	**Reform starting date**	**First pillar**	**Second pillar as share of payroll**	**Projected pension fund assets in 2020 (% of GDP)**	**Workforce in funded pillar in 2003 (%)**	**Switching strategy**
Estonia	1994: phased increase in pension ages for men and women; 2000: early retirement with actuarially reduced pensions	2000: national pensions	1993-2000: Law on State Allowances; 2000: Law on state Pension Insurance	1998: Legal framework for voluntary private pensions	July 2002	PAYG DB	6%	20	60	Voluntary (opt out +2%)
Latvia	1996: NDC scheme; Phased increase in retirement age to 62 for men and women; early retirement abolished from 2005	1996: Introduction of minimum pension; 1997-1998: real pension increases	Creation of State Social Insurance Agency; transfer of collections from SIA to Revenue Service	1997 - Legal framework for regulation of private funds	July 2001	NDC	2% increasing to 9%	20	72	Mandatory <30; voluntary 30-50
Lithuania	1995: abolition of early retirement privileges and increase for men and women	1995: Introduction of flat-rate pension, with earnings-related supplement	1991: Social Insurance Fund separated from State Budget	2000- regulation of private pension funds (no funds established)	Reforms proposed to take effect from 2003, but not enacted	PAYG DB	-	-	-	-
Slovenia	1999: penalties for early retirement and bonuses for later retirement; increase in pension age for women	1999: decreased accrual rates; new valorisation formula reduced replacement rates; introduction of State pension	1992: tighter eligibility rules	Allowed from 1992	-	PAYG DB	-	-	-	-
Russia		1998: Minimum pension	1990: Independent Pension Fund	1992- Law on non-State pension funds	January 2002	NDC	2% (<35) 6% (35-60)	-	-	Mandatory <50

PART I

MOTIVATIONS, PURPOSES AND PROCESSES OF PENSION REFORMS

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Chapter 1

THE POLITICAL ECONOMY OF PENSION REFORM IN CENTRAL AND EASTERN EUROPE

by
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Introduction

In the past decade, many post-socialist countries witnessed not only a fundamental transformation of their societies and economies, but also of their retirement schemes (Fultz and Ruck, 2000; Müller, 2002*b*). In recent years, reforms implying full or partial pension privatisation[1] were started in Kazakhstan (1998), Hungary (1998), Poland (1999), Latvia (2001), Bulgaria (2002) and Croatia (2002), while Estonia and the Former Yugoslav Republic of Macedonia have enacted similar reforms, and are expected to implement them in 2002. Other transition countries, such as Armenia, Georgia, Lithuania, Mongolia, Romania, Russia, Slovakia and the Ukraine, are considering this type of reform for the future. Interestingly, policymakers in the Czech Republic and Slovenia, two of the most advanced transition countries, dismissed the privatisation of old-age security, and decided to improve the financial health of the public pay-as-you-go (PAYG) scheme with a series of parametric reforms, while complementing it with a voluntary private tier.

This study seeks to explain the observable pension reform outcomes in six transition countries, as a result of the interplay of economic and political variables. In so doing, the intention is to contribute to a multi-disciplinary strand of literature, which has developed over the past few years. Recent studies on the political economy of pension reform in Latin America include Kay (1998; 1999), Madrid (1999; 2002), Mesa-Lago (1999), Góra (1999), Huber and Stephens (2000), and Mesa-Lago and Müller (2002). The making of pension reform in post-socialist countries has been analysed by Müller (1999), Cashu (2000*a*; 2000*b*), Orenstein (2000), and Nelson (2001), Brooks (1998; 2001), Madrid (1998; 2001), Chlon-Dominczak and Mora (2001), James and Brooks (2001), Müller (2001*c*; 2002*d*) and Orenstein (2001) seek to provide a cross-regional explanatory framework.

These analyses, which concentrate mostly on the explanation of the recent waves of pension privatisation in Latin America and Eastern Europe, were written in response to a bias in earlier research, which was limited, both in terms of the geographical scope. and of the types of reforms analysed. In spite of their differences in methodology and theoretical objectives, most contributions by economists, political scientists and sociologists show one interesting similarity: they focus on the

1. The notion of pension "privatisation" has been criticised, since the state continues to play a role in the new schemes. Here, the term is thought useful to indicate the scope and direction of the recent reforms in Latin America and the transition countries. For a more detailed discussion of the public/private interaction in the new schemes, see Müller (2002*c*).

remarkable resistance of social security arrangements to substantial downward adjustments, and on the political feasibility of moderate retrenchment.[2] It has been claimed that "pay-as-you-go schemes may face incremental cutbacks and adjustments, but they are highly resistant to radical reform" (Pierson, 2001, p. 416). Ultimately, however, research on the politics of pension reform will need to take into account the full range of policy outcomes.

In order to shed more light on different policy choices, six cases of pension reform in Central and Eastern Europe are analysed in this paper. The two earliest Central European cases, Hungary and Poland, are contrasted with two more recent cases of pension privatisation, in Croatia and Bulgaria. The cases of the Czech Republic and Slovenia are then presented, where policymakers did not opt for the iconoclastic move advocated by the "new pension orthodoxy" (Lo Vuolo, 1996, p. 692). The subsequent section seeks to provide a comparative explanation of the paradigm choices in the post-socialist context. The paper ends with some concluding remarks.

Post-socialist pension reform: six case studies

Privatising pensions in Central and South Eastern Europe

The case of Hungary[3]

By 1989, the need for fundamental reforms in Hungarian old-age security was widely acknowledged, as the inherited pay-as-you-go system was seen as inequitable, inadequate and unsustainable. Its financial problems increased significantly during the economic transformation. Early reforms introduced some changes to the organisation, financing and eligibility of the Hungarian pension scheme, but were not sweeping enough to ensure its financial viability. Inadequate indexation practices added further distortions. Moreover, trade unions succeeded in delaying important reform measures. In contrast, the introduction of voluntary pension funds in 1994 – the first move towards a diversification of old-age provision – did not encounter political obstacles. In spite of the largely unsuccessful attempts to bring about thorough reform within the existing Hungarian old-age pension scheme, the Ministry of Welfare, and the self-government of the Pension Fund, continued to adhere to the Bismarckian and Beveridgean traditions.

Meanwhile, Lájos Bokros, the author of a severe structural adjustment package, put pension privatisation on the political agenda, while serving as Minister of Finance, but it fell to his successor, Péter Medgyessy, to implement radical reform. The stalemate between the Ministries of Welfare and Finance on the pension reform issue lasted for almost two years, until it was finally settled in spring 1996, when Medgyessy threatened to resign. The joint reform blueprint subsequently presented by both ministries strongly resembled the Ministry of Finance's earlier stance. Yet, its mixed overall approach can be interpreted as satisfying both of the previously competing ministries. A pension reform committee led by a commissioner to the Minister of Finance was set up, to work on the planned pension reform, thereby bypassing the previously exclusive competency of the Ministry of Welfare. The reform team was actively supported by the World Bank resident mission in Budapest, and by the United States Agency for International Development (USAID). In mid-July 1997, after only six weeks of parliamentary debate, the government won legislative approval for the envisaged pension reform package.

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2 . For an overview, see Müller (1999).

3. On the politics of the Hungarian pension reform, see Ferge (1999), Müller (1999; 2002*d*) and Orenstein (2000).

Hungary's new pension system, in force since 1998, combines a mandatory public PAYG scheme, with a partially mandatory funded tier, with three-quarters vs. one-quarter of contributions going to each of the tiers.[4] Even though the public tier still plays an important role in Hungarian old-age security, the Argentine-style reform implies a reprioritisation between public and private retirement provision (Charlton e*t al.*, 1998).

It is interesting to note that a socialist-led government enacted the first (partial) pension privatisation in Central and Eastern Europe. As the overall policy context was marked by a rising external debt burden, a near currency crisis, and a drop in Hungary's credit rating, the centre-left coalition was forced to demonstrate its commitment to market-oriented reforms. It can be argued that Hungarian policymakers opted for pension privatisation, to signal their resolve to tackle outstanding structural reforms.[5] The PAYG system's dependence on budgetary subsidies had granted the Ministry of Finance an important stake in the pension reform issue. Thorough parametric reform had already proved difficult to implement, while the public pension scheme exhibited a persistent deficit. Hence, an economic emergency, and the financing needs of the public pension scheme, had resulted in a significant change in the influence of the different actors in the pension reform arena. Once the influence of the principal advocate of the new pension orthodoxy, the Minister of Finance, had been strengthened, he could outweigh the opposition of the Welfare Minister. Moreover, in the light of Hungary's external debt burden, which had been accumulating since the 1970s and 1980s, the international financial institutions (IFIs) were important players.[6] Clearly, agenda shifting in Hungarian old-age security was facilitated by the World Bank, aiming at the creation of a precedent: "Passage of the Hungarian pension reform by Parliament has demonstrated the political and economic feasibility of this type of reform in Central Europe" (Palacios and Rocha, 1998, p. 213).

Pension reform was made politically palatable by a bundling strategy. Most of the politically sensitive parametric reforms were legislated simultaneously with the introduction of individual pension fund accounts – a highly visible move, that distracted public attention away from the changes in the public tier. The funded tier was perceived as granting tangible property rights, while also implying a change of constituencies, by the creation of new stakeholders (Graham, 1997). Moreover, reformers resorted to direct financial compensation, when stipulating a compensatory pension payable to those who partially opted out of the public scheme, and switched to the private funded tier. The extraordinarily quick passage of the pension reform laws in Congress was not only due to the governing coalition's strong parliamentary majority, but also to pre-legislative negotiations with relevant opponents over the pension reform draft, most notably, the trade unions. With regard to corporatism, Congress had made its approval of the pension laws conditional upon the consent of the trade unions. It should be noted, however, that the reformers were only willing to compromise on first-tier reforms, while their basic paradigm choice – partial pension privatisation, instead of a mere parametric reform – was not raised for discussion. This meant that many deficiencies of the public scheme either remained unsolved, or were shelved until 2010 (Augusztinovics *et al*., 2002). The government's strategy to opt for a mandatist approach to the legislature – instead of using Congress as

4. From July 1998, all new entrants to the labour market were obliged to join the two-tier scheme, alongside the public pension tier (mixed pension path). Individuals who already had an insurance history but were not yet retired could do the same – alternatively, they could stay in the old scheme (the purely public pension path). From 2002, the Orbán government reopened the purely public pension path to new entrants to the labour market. For more details, see Augusztinovics *et al.* (2002).

5. James (1998) points to the fact that Hungary's credit rating from Moody's improved after partial pension privatisation was adopted, in spite of the fiscal costs of the move.

6. According to the World Bank classification (1996), Hungary suffered from moderate indebtedness at the time of the reform.

a policy forum to build political consensus for the iconoclastic laws – ultimately backfired, as the incoming Orbán government showed little commitment to the reform, and changed some of its basic parameters (Müller, 2002*d*).

The case of Poland[7]

While economic crisis had afflicted Poland's main pension system, ZUS, since the 1980s, the financial strain was greatly aggravated by the economic transformation. However, policymakers had experienced strong resistance from the "grey lobby", when they attempted to introduce relatively modest reforms. Subsequently, the Ministry of Finance, and economists, advocated Latin American-style pension privatisation, while the Ministry of Labour, and professors of social insurance law, argued that a thorough reform of ZUS was sufficient. For a year and a half, pension reform was deadlocked by the conflict between the Ministries of Labour and Finance. In early 1996, after a cabinet reshuffle, a new Minister of Labour, Andrzej Baczkowski, was appointed, and quickly became the most important individual actor in Polish pension reform, moving his Ministry considerably closer to the position of the Ministry of Finance. The idea was to combine a reformed, downsized ZUS, with a newly created, mandatory fully funded tier, and to get all the pension reform laws passed before the parliamentary elections, due in September 1997. However, Baczkowski's sudden death delayed reform preparations.

Eventually, the outgoing government, dominated by the post-socialist SLD, enacted the new private pension fund tier before the elections, and presented itself to the electorate as the author of a nearly completed pension reform. The more intricate part – the ZUS reform, without which the private tier could not come into force – was left to the incoming government, formed by Solidarity and the liberal UW. Throughout the entire legislative process, the pension reform team negotiated with potential opponents of the envisaged reform, notably trade unions and pensioners' organisations, and agreed to some modifications of the first pillar reforms, which were finally enacted in late 1998. Poland's new pension system came into effect in 1999. The old ZUS scheme was fundamentally restructured, the most important change being a shift towards the notional defined contribution (NDC) principle.[8] In addition, a new private pension fund tier was set up, to which 37.4% of contributions are channelled, while 62.6% continues to go to the first tier.[9] The introduction of an NDC scheme makes Polish first-tier reforms more sweeping than those in Hungary.

The severe transitional crisis was already over, when this iconoclastic reform package was being prepared. Yet, fiscal imbalances persisted, and the pension system was seen as "the most important source of the budget deficit" (World Bank, 1997*b*, p. 72). By that time, Poland was still severely

7. On the politics of the Polish pension reform, see Müller (1999 and 2002*d*), Orenstein (2000), Hausner (2001) and Nelson (2001).

8. In NDC schemes, all contribution payments to the public pension insurance scheme are recorded on individual accounts, but capital accumulation is only virtual. Individual benefit levels depend on the sum of contributions and their notional rate of return, while also reflecting mortality rates and the chosen retirement age. NDC plans have been developed by Swedish experts, but were pioneered by Latvia in 1996.

9. All Poles under the age of 30 are obliged to join the new two tier scheme, paying 7.3% of gross wage to a private pension fund of their choice, while the remaining 12.22% continues to flow to ZUS (the mixed pension path). Those aged between 30 and 50 were free to do the same – alternatively, they could stay in the reformed ZUS, with the whole of the pension contribution, *i.e.* 19.52% of gross wage, flowing into it (the purely public pension path). Those aged over 50 were required to remain in the old system. For more details, see Chlon-Dominczak (2002).

indebted,[10] and closely monitored by its creditors, who expressed concern about the slow-down of reforms. By the mid-1990s, pension privatisation was much recommended by the World Bank, and soon turned into a key element on Poland's outstanding agenda of structural reforms. As in Hungary, the move was initiated by an "unlikely" post-communist government, facing a special need to signal its commitment to market-oriented reforms, and to fiscal sustainability.[11] The macroeconomic blessings ascribed to pension reform, and the fiscal impact of ZUS, turned the Minister of Finance, Grzegorz Kolodko, into a key actor in the pension reform arena, allowing him to emerge as the winner, from his conflict with Labour Minister Leszek Miller. Afterwards, Miller's successor, Baczkowski, took a lead in the pension reform project. Contrary to their Hungarian counterparts, Polish reformers managed to build a cross-party consensus on the need for structural pension reform, allowing for a continuation of the unfinished legislative agenda, in spite of the 1997 government change. The political alternatives were clearly less attractive: a continuation of the high subsidies to ZUS, at the expense of other government expenditures, or drastic retrenchment in the public pension system – a politically sensitive, if not impossible, move, given that the Constitutional Court had effectively vetoed modifications of acquired pension entitlements (Hausner, 2001).

The World Bank supported the Polish pension reform with expertise, international networking, and financial assistance. A special task force for pension reform was established, headed by Michal Rutkowski, an economist on leave from the Bank, in an effort to circumvent intra-government resistance. The reformers' early idea, to bundle the sensitive ZUS reforms with the introduction of the new funded tier, was soon replaced by deliberate unbundling, and sequencing, thereby enabling fundamental pension reform in a pre-electoral context. The incoming government decided to bundle up pension privatisation with three other major public sector reforms, starting simultaneously on 1 January 1999. This strategy has been linked to the severe implementation problems that occurred, as there was virtually no *vacatio legis*. It should be noted that pension reform was legislated by the only two subsequent post-1989 governments with a large majority in Congress. Nevertheless, policymakers did not opt for mandatism, but for parliamentarism and concertation, negotiating with the opposition in the legislature and beyond. They compromised only on first-tier reforms, not on pension privatisation.

The case of Croatia[12]

In the 1980s, when Croatia still formed part of Yugoslavia, and the country was hit by a severe economic crisis, a federal law introduced wage-based pension indexation, to halt the decrease in the standard of living of the elderly. Consequently, replacement rates reached more than 90% of wages (World Bank, 1997*a*). After independence, economic transformation, and the consequences of the war, only added to the dire situation of Croatia's pension finances, as the ratio of contributors to retirees experienced a dramatic drop. As part of the 1993 fiscal adjustment package, the wage-based indexation of retirement benefits was discontinued. Other parametric changes were put off during wartime, yet the continuous worsening of all relevant indicators made it ever more evident that comprehensive pension reform was unavoidable. The paradigmatic turning-point is marked by an international conference on pensions held in Opatija in November 1995, attended by José Piñera and other prominent experts. It was at this conference, sponsored by the World Bank, that the Prime Minister publicly endorsed the introduction of a mandatory funded tier. The Chilean reformers had managed to

10. It was only in the second half of the 1990s that Poland's status changed from "severely indebted" to "less indebted" (World Bank 2001*b*).

11. For the credit that the move earned, see World Bank (1999*b*, p. 10): "Poland can take pride in the fact that it is one of a limited number of countries which has successfully launched a complete restructuring of its social security system".

12. On the politics of pension reform in Croatia, see Müller (2002*d*).

challenge the strong cognitive reference point that the German model had constituted in Croatia's early post-independence years.

However, the fiscal implications of pension privatisation were a matter of concern, leading to a lowering of the envisaged second-tier contributions, from 10 to 5% of wages. In 1997, a World Bank report recommended a sequenced strategy: if first-tier reforms were carried out first, cutting down on existing pension entitlements, they would allow for a lowering of the subsequent transition costs of partial pension privatisation. In the same year, a law on first-tier reforms was submitted to Congress. In its first two articles, it established the three pillar model, although the second and third tiers required separate legislation. In 1998, when the first-tier law had its second reading, the Constitutional Court ruled on the suspension of the wage-based indexation of pensions. The move was declared unlawful, and pensioners were to be compensated for the drop in replacement rates. With its significant fiscal implications, the verdict provided a major impetus for the approval of the first-tier law, while also distracting public attention from the parametric changes. Second and third-tier legislation was passed in May 1999.[13] The political regime change, which occurred in early 2000, delayed the establishment of the funded tiers until January 2002, while the first-tier reforms had taken effect from January 1999.

In 1994, when the World Bank published its global pension reform proposal, Croatia had not yet gained access to international capital markets, and depended on the IFIs for external financing, while the war and its consequences amounted to a severe drain on the state budget. With its ascribed potential to boost the rate of domestic savings, policymakers hoped that pension privatisation would give them more financial leeway. At the same time, the move seemed useful to signal the government's commitment to market-oriented reforms, at a time when the country suffered from political isolation, and had fallen behind in the transition to a market economy.[14] By all accounts, the World Bank was the principal agenda shifter in the Croatian pension reform arena.[15] The Bank sponsored the crucial Opatija conference, and subsequent preparatory work, provided technical assistance, financed IT systems, and promised a loan to co-finance transition costs. It is interesting to note the double role of former Assistant Finance Minister Anusic, a key domestic actor, who later joined the Bank, and was then seconded to the Croatian pension reform team.

Throughout the reform process, the Ministry of Finance played an important role, while the Ministry of Labour remained passive. The Pension Institute, running the public old-age security scheme, rejected the funded tier, while actively preparing first-tier reforms. The strong role of the Ministry of Finance in pension privatisation, can be linked to the ever-worsening financial situation of the public pension scheme, translating into substantial budgetary transfers. The atmosphere of crisis intensified significantly, after the Constitutional Court ruling on the indexation problem, thus facilitating the passage of substantial first-tier reforms. However, the considerable delay in legislating and implementing pension privatisation in Croatia, revealed concerns that the move would worsen the

13. The insured are divided into three age-groups: for those younger than 40, it is mandatory to split the contribution between the reformed PAYG tier (14.5% of wages) and the second, funded tier (5% of wages). Those aged between 40 and 49 are given six months to choose between the mixed and the purely public pension path, while those aged 50 and above are mandated to stay in the public tier, with their entire contribution (19.5% of wages).

14. When the three-pillar model was eventually legislated, the move earned its credit: "Pension reform is a policy area in which Croatia joined the ranks of other reformers in Central and Eastern Europe" (World Bank, 2000*a*, p. 8).

15. Jacoby (1998, p. 18) has defined agenda shifting as the power to intervene at critical moments, introducing crucial new models in a policy arena.

severe financial situation of the Pension Institute, in the short and medium run, thus complicating compliance with budgetary targets. Moreover, in the Croatian case, poor capital market development was perceived as a constraint to the swift introduction of a mandatory funded tier.

To ensure passage of the reform laws, the Tudjman regime relied on a mandatist style, without making a great effort to achieve consensus with opposition parties, and social partners (Zrinscak, 2000). The sequencing strategy chosen by the Croatian government, which started with the downsizing of the public scheme, and then the introduction of a funded tier – this latter only three years later – also deserves attention, and can be linked to a fiscal rationale. Unbundling was not complete, however, as the government had stipulated the multi-pillar approach, in the first two articles of the first-tier law. The Tudjman era was marked by authoritarian traits, a single majority party, and a powerful presidency. Interestingly, this context did not guarantee quick pension reform – six years elapsed between the first public announcement of pension privatisation at Opatija, and its actual implementation, while it is also remarkable that the iconoclastic project survived a major change of regime.

The case of Bulgaria[16]

The process of economic transformation had a profound impact on the Bulgarian PAYG scheme. The number of insured plunged, as many workers lost their jobs, while others left the country, in search of a better future. At the same time, the number of old-age pensioners in the general scheme increased substantially. The system dependency ratio jumped to 82.7% in 1994, and the pension scheme was in permanent need of subsidies from the state budget. At the same time, average replacement rates had dropped to a mere 29% of average monthly salaries, by 1997, leading to a crisis of confidence in the public scheme. "At present, in Bulgaria, old age is virtually synonymous with poverty" (Ministry of Labour, 1994, p. 77).

In post-1989 Bulgaria, a frozen communism/anti-communism cleavage resulted in short-lived governments, with political modernisation, and economic reform, running markedly behind schedule. Bulgarian pension reformers had received conflicting advice from the International Monetary Fund (IMF) and the World Bank, on the one hand, and the International Labour Organisation (ILO), on the other. In a White Paper, the Labour Ministry explicitly rejected the idea of pension privatisation (Ministry of Labour, 1994). Fully reflecting the "new Bulgarian political system of post-communist corporatism" (Deacon and Vidinova, 1992, p. 86), only the existing minimum consensus between the government and the social partners became law in 1995: pension finances were separated from the budget, and an autonomous National Social Security Institute (NSSI) was created, featuring a tripartite supervisory board. When the NSSI needed to be equipped with sophisticated information technology, the Bulgarian government decided to approach the World Bank, and was promised help. The loan for the public pension scheme triggered the socialist government's commitment to a supplementary funded tier, for privileged labour categories, while the Bank's initial proposal to downsize the public tier to a flat-rate scheme was rejected, in the light of the country's long social insurance tradition.

The World Bank's leverage, and agenda shifting. took effect in a two-step process. While the funded tier was initially limited to those occupations that enjoyed privileged treatment, the second-tier plans were extended to include a universal funded scheme, when a centre-right government took office in 1997. In the midst of an acute economic crisis, and near-default on the country's external debt, the first government in post-1989 Bulgaria to serve its entire term of office was fully committed to multi-lateral recommendations on economic policy. In this context, pension privatisation was useful, to

16. On the politics of the Bulgarian pension reform, see Müller (2002*d*).

signal the government's commitment to a market-oriented course. Moreover, there was interaction among structural reforms: the strict fiscal discipline, required under the newly introduced currency board arrangement, heightened the impetus for pension reform, while reformers also thought that private pension funds could transform privatisation vouchers into tangible benefits. This account points to a two-layered crisis, shaping pension reform: initially, the dire state of the pension system turned far-reaching reform into a necessity, while the subsequent decision in favour of partial pension privatisation was taken in the midst of a general economic emergency, that granted the IFIs a powerful role, enabling them to condition structural adjustment loans to pension privatisation.

As to local actors in the Bulgarian reform arena, it is remarkable that the Ministry of Labour took the lead in all pension reform preparations throughout the 1990s, even after the paradigm change, while the Ministry of Finance played a less visible role than elsewhere. Moreover, it is interesting to note that trade unions turned out to be supportive of the envisaged multi-pillar model. Previously, they had been granted a role in the tripartite board of directors of the NSSI, and were thus aware of the PAYG scheme's financial difficulties. Moreover, both trade union confederations – the post-communist KNSB, and the independent Podkrepa – had developed business interests in the pension fund industry that preceded structural pension reform. In a similar vein, Labour Minister Ivan Neikov's harmonious co-operation with the new pension orthodoxy can be related to the fact that he had been a vice-president of the KNSB, while also serving a spell on the managing board of its private pension fund, Doverie. Other participants in the voluntary pension fund sector, such as insurance companies, were also among the stakeholders inclined towards a mandatory funded tier, although the strict third-tier regulations turned out to affect the industry.

The Bulgarian reformers chose a sequenced approach to the legislative process. While legislation for the first and second tiers was still being prepared, the need to regulate the existing third-tier industry meant that legislation on this issue was sent to Congress ahead of the other laws, and was passed in July 1999. Afterwards, the Mandatory Social Insurance Code, the main legislation covering all obligatory pension tiers, was submitted to Congress. Most objections to it concerned the first-tier legislation, and reformers had to compromise on the increase in the retirement age, at the request of the trade unions. Moreover, parliamentarians gave in to pressures from the pension fund sector, to move the envisaged start of the universal second tier forward from 2004 to 2002, while the cut-off age was increased, thus speeding up second-tier development, and guaranteeing a larger market. Eventually, the pension reform package was approved in December 1999, and was phased in gradually, from January 2000 to January 2002, supported by a USAID-sponsored team of experts.[17]

The Bulgarian reform process was marked by a corporatist policy style. Although trade unions were not vested with formal veto points, pension reformers made an effort to obtain their consent, both before, and during, the legislative process. Familiar with non-Bismarckian types of pension provision, and already having stakes in the pension fund industry, they turned into important allies of the pension reform team, the cuts in the public scheme notwithstanding. Congress was another important forum to discuss and negotiate the reform; hence, the reform process also exhibits parliamentarist features.

17. The first tier, run by the NSSI, underwent substantial reform, and is still mandatory for all insured. The second tier consists of occupational funds and of universal pension funds. The former scheme started in January 2000 and is run by private pension funds. Since then, employers are mandated to contribute 12% for their first category workers, and 7% for their second category workers, to these newly created institutions. Universal second tier funds started operation in January 2002. Participation in these new institutions is mandatory for third category workers born after 1959, who must redirect part of their first tier contributions – to be gradually increased from 2 to 5% of wages – to one of the private pension fund administrators. For more details, see Chiappe (2001) and Müller (2002*d*).

Meanwhile, this iconoclastic reform has survived its first regime change, after being endorsed by the newly elected government of Bulgaria's ex-monarch, Simeon Saxe-Coburg-Gotha.

Dismissing pension privatisation in the Czech Republic and Slovenia

The case of the Czech Republic[18]

Compared with other post-socialist countries, the drop in the insured/pensioner ratio, occurring in the context of economic transformation, only hit the Czech Republic in the second half of the 1990s, after economic crisis had pushed up unemployment rates. In the first half of the decade, when labour market indicators were still relatively favourable, the basic conflict surrounding pension reform in the Czech Republic had been about the scope of parametric reform. Against the fierce opposition of trade unions, the government obtained parliamentary approval for a very controversial Pension Insurance Act in 1995, which introduced a two-part pension formula, and raised the retirement age. Advocates of full or partial pension privatisation made themselves heard only afterwards. Young Czech economists connected with the international orthodoxy – "market komsomols" in local jargon – had joined forces with the stakeholders from the local financial community, and the liberal Union of Freedom, to place pension privatisation on the political agenda.

However, these efforts at agenda shifting did not succeed in having an impact on the overall reform strategy, pursued by the Czech government. After simulating the impact, and costs related to a partial privatisation of the pension scheme, as against the alternative, a thorough reform of the existing pension scheme, the experts at the Ministry of Labour concluded that there was still sufficient leeway within the existing public PAYG system, to face the challenges of the future decades. The World Bank, the main promoter of pension privatisation elsewhere, was absent from the Czech reform arena. The Bank's lack of leverage in the Czech Republic coincided with a low level of external debt.

For almost a decade now, the only portfolio involved in the Czech pension reform efforts, has been the Ministry of Labour and Social Affairs, traditionally inclined towards Bismarckian and Beveridgean concepts. As the public pension scheme was financially viable, without subsidies from the general budget, until contribution rates were lowered in 1997, it came as no surprise, that the Ministry of Finance, a potential intra-governmental advocate of pension privatisation, had no stake in pension reform. However, the Czech pension scheme has been in the red for almost five years now, and successive Finance Ministers have still remained passive. One possible explanation is related to the fact that pension privatisation implies substantial fiscal costs, in the short and medium term. On the other hand, it should be recalled that a severe economic and financial crisis hit the Czech Republic in 1997. Given the still shaky bases of the local capital market, the introduction of a mandatory funded tier was deemed particularly inappropriate. Owing to the substantial costs of bank bailouts, the financial sector crisis also became a fiscal burden, thereby contributing to a narrowing of the budgetary scope for pension privatisation.

The Czech trade unions, another relevant political actor, used to be fierce critics of the parametric reforms envisaged in the first half of the 1990s. This became particularly manifest during the conflicts surrounding the 1995 Pension Insurance Act. Even if they were in no position to veto this law, their opposition raised public awareness about the unpopular retrenchment measures, and contributed substantially to the electoral defeat of the conservative coalition in 1996. Yet, with the appearance of pension privatisation on the Czech agenda, the unions changed their stance. Instead of pushing for the maintenance of the status quo, they now claim that the existing options for reform of the public PAYG

18. On the politics of the Czech pension reform see Müller (1999; 2002*a*), Vecernik (2001) and Mácha (2002).

scheme have not yet been exhausted in the Czech Republic, opposing a full or partial shift to funding. Given the vociferous role that unions have played in the past, policymakers are likely to take them into account, in spite of the absence of strong corporatist decision-making structures in the Czech Republic. Politically, their campaigns translated into support for the Social Democrats, and the Pensioners' Party, with the latter single-issue party failing to enter parliament.

This country's paradigm choice, beyond the dominant international mainstream, might appear particularly surprising, given the neo-liberal discourse of the long-standing Czech Prime Minister, Václav Klaus – seemingly an excellent ideological match for the new pension orthodoxy. However, Klaus frequently departed from his "market economy without an adjective" rhetoric, when it came to practical politics (Stark and Bruszt, 1998). His favourite pension reform path involved very low replacement rates in the public tier, to create incentives for Czechs to join the new voluntary pension tier, introduced in 1994. Klaus, inspired by Thatcherite social policy, and an outspoken critic of corporatism, had pushed for an individualistic approach. A proposal by the Ministry of Labour and Social Affairs, supported by trade unions and employers' associations, to introduce occupational pension schemes as in Continental Europe, was dismissed.

It should also be remembered that since 1996 – *i.e.* the very moment when the Poles and Hungarians started preparing their partial pension privatisations – Czech governments could not count on a parliamentary majority. The Social Democrats, governing since 1998, were opposing pension privatisation, together with their main political ally, the trade unions. Public support for such a paradigm shift was also minimal (Vecernik and Mateju, 1999, p. 201). During previous years, the executive's control of the legislature was so limited that the government's plans for a substantial parametric reform were not politically feasible either, thus only increasing their urgency. After the June 2002 elections, a coalition, formed between the Social Democrats and a centrist alliance of the Christian Democrats, and the Freedom Union, holds 101 seats out of 200. It can only be hoped that this tiny majority will suffice to bring about the much-needed changes to the Czech PAYG scheme.

The case of Slovenia[19]

In Slovenia, high replacement rates dating from the recent Yugoslav past led to a high level of pension expenditure, second only to Poland in the entire post-socialist region. With net replacement rates peaking at 89% of wages in 1990, and still reaching 76% in 2000, the Slovene Institute for Pension and Disability Insurance relied on budgetary transfers, throughout the whole decade. Contrary to other transition countries, Slovenia enjoyed considerable fiscal leeway, but the level of these ever-rising transfers indicated the need for action. In Slovenia, two major legislative efforts to fix the PAYG system stand out – the Pension and Disability Insurance Acts of 1992 and 1999. While the former mainly introduced stricter eligibility rules, the 1999 Act followed four years of substantial negotiations, both within the ruling coalition, and with the social partners. It introduced a system of penalties and bonuses for early and delayed retirement, increased the pensionable age for women, decreased accrual rates, and further tightened eligibility. It also transformed branch privileges into an employer-financed, pre-funded scheme, managed by Kapitalska druzba, the Pension Management Fund.

Although a shift to a universal funded tier was eventually disregarded by local policymakers, the new orthodox template did play a temporary role in the Slovene pension reform arena. According to the account in Stanovnik (2002), the relevant agenda shifters in the local reform debate appear to have been the IMF and the World Bank. During an expert mission to Slovenia in 1995, the IFIs emphasised

19. On the politics of the Slovene pension reform, see Stanovnik (2002) and Müller (2002*a*).

the need for more fundamental reforms in the public pension scheme, and also proposed the introduction of a multi-pillar scheme. Subsequently, the World Bank sought to support pension privatisation in Slovenia, by means of an earmarked loan, while also co-sponsoring an international pension conference in October 1997, and a workshop on second pillar issues in March 1998, both held in Ljubljana, as well as trips to Switzerland and the Netherlands, for first-hand experiences with multi-pillar schemes.

As regards local actors, the multi-pillar agenda was pursued by Tone Rop, clearly one of the most influential individual policymakers in Slovenia, and a leading figure in the LDS – the centre-left party that has dominated Slovene politics, since independence. An economist, and former State Secretary of Privatisation, he assumed the Ministry of Labour, after the resignation of his social democratic predecessor, in 1996. Pension reform soon became his top priority. The initial policy document, elaborated with a significant input from Milan Vodopivec, a former World Bank official, strongly advocated partial pension privatisation. The subsequent White Paper on Pension Reform was co-authored by a team of Phare consultants, among them a leading ILO specialist. These French and Italian social security experts took a more cautious stance on the proposed mandatory second tier, notably with regard to its fiscal implications, a concern corroborated by simulation exercises. However, the final version of the white paper, published in November 1997, still included pension privatisation.

When the white paper was discussed with the social partners in a working group in January 1998, the Slovenian trade unions used this pivotal chance to veto pension privatisation irrevocably. Soon thereafter, they held several large rallies, against some of the envisaged parametric reforms and the introduction of a mandatory second tier. The Pensioners' Party, another ally within the "grey lobby", and a member of the governing coalition during the pension reform process, also declared its opposition. Moreover, criticism of the government's plan to partially privatise old-age security was raised by some well-known social security experts with a background in economics and law. One of the most influential Slovene economists, Velimir Bole, highlighted the substantial fiscal costs of the proposed multi-pillar scheme, in a paper commissioned by the World Bank. At this point, the Minister of Finance, Mitja Gaspari, publicly declared that a mandatory second tier would not be fiscally feasible, inducing Tone Rop to give up on pension privatisation.

At a cabinet meeting four weeks later, the pension reform course was quietly changed. The draft law on pension and disability insurance, approved by the Slovene government in June 1998, proposed a reform of the public PAYG scheme, in combination with the introduction of a voluntary funded tier. As noted above, a small mandatory funded scheme, run by Kapitalska druzba, on a supplementary basis, covers only those insured involved in particularly hard and unhealthy work, or performing activities that cannot be continued after attaining a certain age. After lengthy negotiations within the ruling coalition, and with the social partners, this pension reform law was passed in December 1999. Due to the rather broad political alliance governing Slovenia from 1997 to 2000, policymaking was characterised by a search for consensus, rather than by the rapid enforcement of radical structural reforms.

A comparative analysis of pension reform choices

The new pension orthodoxy

In many East European countries, the public-private mix in mandatory pension provision has been changed, significantly, over the past decade. Before structural pension reform was implemented, monolithic public pension systems dominated the post-socialist region, and supplementary private old-age schemes were introduced only gradually. The above account has shown that, by now,

policymakers in several countries of Eastern Europe, and the former Soviet Union, have introduced private old-age provision, on a mandatory basis, while at the same time downsizing the public tier.[20] The recent move towards pension privatisation implied the adoption of a "worker-choice model" (Lindeman, Rutkowski and Sluchynskyy, 2000, p. 32). This system of individual retirement savings accounts, managed by competing pension funds, has also been dubbed the "mandatory, forced saving program" (Hemming, 1998, p. 22).

An increasing amount of contemporary policy change is affected by policy transfer, and the global diffusion of models (Dolowitz and Marsh, 2000). Conservative critics of the welfare state had long prepared the ground for a paradigm change in old-age security, as described by Hirschman (1991). However, it was the cognitive availability of the Latin American precedents which was pivotal in turning pension privatisation, from a theoretical concept, into a political reality (Weyland, 2001).[21] It was in the wake of the end of the cold war, that the terms of the prevailing discourse on old-age protection shifted, interacting with the rise of neo-liberalism, as the dominant paradigm in economic policymaking, particularly in developing and transition countries. Today, a dominant epistemic community[22] can clearly be identified: a new pension orthodoxy has given a major impetus to pension privatisation, arguing that such a paradigm change in old-age security would lead to both a rise in saving, and to efficiency improvements in the financial and labour markets, thereby resulting in an increase in long-term growth (*e.g.* Corsetti and Schmidt-Hebbel, 1997).[23]

The recent wave of full or partial pension privatisation, *i.e.* the adoption of similar blueprints across countries, suggests a common international transmission mechanism of ideas. Although individual Latin American reformers passed their experiences on to East European policymakers, in person or via their writing,[24] the effects of a direct diffusion of ideas from Chile, and other Latin American reform precedents, were rather weak in the post-socialist region, with the exception of Croatia and Kazakhstan. Latin America carried the stigma of being a less developed region (Orenstein, 2000), making it unsuitable as a benchmark case. However, Latin American-style pension privatisation was recommended as a major reform option by the IFIs, most notably the World Bank (World Bank, 1994; Vittas, 1997). While originally not contained in the Washington Consensus (Williamson, 1990; 2000), pension privatisation has since become part and parcel of the neo-liberal reform package. To provide first-hand information on Latin American pension reforms, the World Bank, and USAID, also sponsored trips to Argentina and Chile, for Polish and Bulgarian members of parliament, social security experts, and journalists.

Hence, in Central and Eastern Europe, where the connotations of the "Chilean model" were more likely to refer to the Pinochet regime, than to a regional example of economic success, the IFIs played

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20. The only transition country where the public scheme was closed altogether was Kazakhstan (Andrews, 2001).

21. On the Latin American pension privatisations, see Devesa-Carpio and Vidal-Meliá (2001), Mesa-Lago (2001) and Müller (2000, 2001*b*).

22. An epistemic community is a network of professionals in a particular domain and with a common policy enterprise, who may come from different professional backgrounds. They share a faith in specific truths and in a set of normative and causal beliefs, have shared patterns of reasoning and use shared discursive practices (Adler and Haas 1992; Haas 1992).

23. A sizeable heterodoxy remains, however. Mesa-Lago (1996) and Ney (2000) point to conflicting policy prescriptions by international organisations. For the debate between the World Bank and the ILO, see Beattie and McGillivray (1995) and James (1996). For a recent critique of the new pension orthodoxy, see Barr (2000), Charlton and McKinnon (2001) and Orszag and Stiglitz (2001).

24. See, *e.g.* Piñera (1996; 1997; 2000; 2001) for appeals to Poles, Croats, Russians and Romanians.

an important, though mostly low-key, role, as agents of transmission, helping to enhance the low status of the Latin American precedents (Nelson, 2000; Müller, 2001*a*).[25] Apart from the ubiquitous conditionalities, channels to support pension privatisation include loans, and an expert-based knowledge transfer – a potentially attractive assistance package for local policymakers. Although the IMF and USAID have taken part in relevant cross-conditionalities with the Bank, as well as other forms of co-operation, overall, they play a less outstanding role.

Political actors and the policy context in pension reform

While the privatisation of old-age security was clearly a major policy recommendation from abroad, facing any pension reformer in Central and Eastern Europe, it was the domestic, political process that eventually resulted in the adoption, or rejection, of radical pension reform, as the above case studies have made clear. The following analysis includes the identification of relevant political actors in the pension reform arena, and the consideration of the policy context that shaped their room for manoeuvre, which was influenced by political factors, and economic conditions.

Scholars of the political economy of policy reform[26] have stressed the importance of political leadership – courageous, committed individuals, often market-oriented economists – and their ability to communicate a coherent vision (Harberger, 1993; Sachs, 1994). Pension privatisation amounts to a paradigm shift that may be greatly facilitated by such committed policymakers, famous for the radical economic reforms they pushed through, such as Bokros in Hungary. In Poland, there is unanimity that radical pension reform would have been impossible, without the initial push by Baczkowski. Rutkowski and Anusic, World Bank economists on leave, played an important role in Poland and Croatia. However, the existence of such agenda setters can certainly not be considered sufficient to guarantee success against powerful interest groups (Williamson and Haggard, 1994; Tommasi and Velasco, 1996). This is particularly highlighted by the Slovene case, in which one of the most influential individual policymakers could not impose pension privatisation against the opposition of the unions and the Finance Ministry.

Bresser Pereira, Maravall and Przeworski (1993, p. 208) have pointed out that policy reform has been pursued in four distinct styles: while decretism (reliance on presidential rule by decree) and mandatism (executive use of a legislative majority to short-cut legislation) are two exclusive, technocratic policy styles, parliamentarism and corporatism/concertation involve extensive negotiations with opposing forces in the legislature, and beyond. The "technocratization of decision-making" (Silva, 1999, p. 58) has been criticised, as it weakens democratic institutions, and rules out the consensus building required for political sustainability (Bresser Pereira *et al.*, 1993; Stiglitz, 2000). A parliamentarist and/or corporatist policy style was chosen in Bulgaria, Poland and Slovenia. Pension privatisation was pushed through by mandatism in Croatia. Corporatism was combined with mandatism in Hungary, a case highlighting the fact that insufficient consensus-building can lead to severe alterations in reform design, by subsequent governments, and ultimately threaten the sustainability of the move.

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25. In this context, it is interesting to note that "adopters eventually become source countries themselves" (Kay 1998, p. 47). Argentina, which set out to replicate the "Chilean model" and ended up with a mixed variant, later exported its model to the transition countries. Later, partial pension privatisation in Poland and Hungary seems to have triggered a wave of regional imitators from the Baltics to the Balkans.

26. For an overview on the political economy of policy reform, see Rodrik (1996), Tommasi and Velasco (1996), Sturzenegger and Tommasi (1998), Drazen (2000) and Krueger (2000).

When it comes to institutional or individual actors, who have been relevant in the pension reform arena, most of the above cases of pension privatisation have witnessed the Ministry of Finance as a key player. This Ministry is often staffed with neo-liberally trained economists, who feel that pension privatisation perfectly matches their overall efforts to decrease the role of the state in the economy. The role of the Minister of Finance was especially pronounced in Poland, Hungary and Croatia. This actor, for whom pension privatisation was a means to achieve macroeconomic, rather than social, objectives, was supported by local interest groups, such as business organisations, and the financial sector, as well as the IFIs. In contrast to this, the Ministries of Labour or Welfare, responsible for the existing old-age security schemes, were often reluctant to engage in structural pension reform, thus reflecting the existing Bismarckian traditions in Central and Eastern Europe. In Poland and Hungary, these ministries objected to the radical paradigm shift, but – given the predominance of the Finance Ministry in the cabinet – proved too weak to prevent it. In many cases of pension privatisation, the Labour Ministry's influence on reform design was deliberately limited, by the setting up of small task forces, that worked out the draft legislation, and served to bypass the Labour Ministry's pension-related competences (Müller, 1999; Nelson 2001). This policy pattern confirms the technocratisation of decision-making, and the key role of "insulated policy-making elites", in pension privatisation (Schamis, 1999, p. 265). In Poland and Bulgaria, Labour Ministers, who had rejected the shift to funding, were replaced with new Ministers, who had a prior commitment to a mandatory funded tier, in order to facilitate the iconoclastic move. In Slovenia, the ideological distinctions between both Ministries proved to be less clear-cut: the Minister of Labour, an economist, was the principal advocate of partial pension privatisation, but was vetoed by the Minister of Finance, and the trade unions.

In many countries, social security employees, pensioners' associations, and/or special interest groups with privileged pension schemes, have opposed pension privatisation. In the post-socialist world, trade unions have also been dubbed "pensioners' parties", since many of their members are retired. In the Czech Republic and Slovenia, plans to reform old-age security triggered the largest political rallies since independence. It is interesting to note that the Czech unions voiced strong opposition to the 1995 pension reform law, but started to advocate parametric reforms, when pension privatisation appeared on the political agenda. The Pensioners' Party failed to enter Parliament in the Czech Republic, but formed part of the governing coalition in Slovenia, at the time of the 1999 reform. In contrast to this, Poland's Solidarity trade union participated in the conceptual debate on systemic pension reform, with an early proposal in support of a partial shift to funding. In Croatia, most trade unions voiced opposition to pension privatisation, except for the union of state employees, which considered setting up a second-tier pension fund. Interestingly, the retired persons' trade union also agreed with the move to funding. Trade unions in Bulgaria also supported partial pension privatisation, given their business interests in this industry.

Nor did left-wing parties always join the ranks of the opponents to a shift to funding. There have been many cases where market-friendly reforms have not been carried out by conservative free marketers, but, rather, by left-wing governments – a phenomenon called the "Nixon-in-China syndrome" (Rodrik, 1994). Among the above case studies, the post-socialist governments in Poland and Hungary are among the "unlikely" administrations involved in pension privatisation. It has been argued here, that in a context of high indebtedness, these left-wing governments were under stronger pressure, from international creditors, to demonstrate their commitment to market-oriented reforms. Moreover, they were better suited to handle opposition from trade unions. In both Hungary and Poland, the governing parties had traditional ties with the unions, and used them to ease resistance. On the other side of the coin, these ties implied that pension reformers were forced to negotiate with reform opponents, and to make concessions.

The specific policy context may provide reformers, or reform opponents, with the resources for action. The executive's degree of control over the legislature, amounts to an important, institutional variable. In Bulgaria and Hungary, the large parliamentary majority, enjoyed by the governing coalition, allowed for a swift passing of structural pension reform. Contrary to this, in the Czech Republic and Slovenia, the political conditions, in the second half of the 1990s, were less than propitious for pursuing radical reform. Due to the broad character of the coalition in Slovenia, the need to embark on consensus building prevailed, while successive minority governments, in the Czech Republic, seemed to allow for very little leeway in policymaking. Yet, strong governments do not always embark on radical reform, either, as concentrated authority is tantamount to concentrated responsibility, providing little chance of blame avoidance (Pierson, 1996). Pension privatisation in Croatia – the outlier, in terms of the Freedom House country rating, during the Tudjman era – was by no means faster or more radical, than in the other cases. A closer look reveals a wavering commitment, by the President and the ruling party, to the iconoclastic paradigm shift. Clearly, in a context of concentrated authority, leadership in policy reform initiatives is the key factor.

Economic factors and considerations, have had a substantial impact on the choice of reform model. As noted above, pension privatisation has been primarily proposed for macroeconomic motives, to embark on a virtuous circle, leading to economic growth. Madrid (1998), and James and Brooks (2001), have pointed to increased international capital mobility, and the recent experiences of capital market crises, that may have induced policymakers to seek to reduce their vulnerability to capital outflows, by boosting domestic savings, and the local capital market.[27] Moreover, scholars of the political economy of policy reform have highlighted the fact that that a preceding crisis may induce radical change – the so-called "benefit of crises" hypothesis (Drazen and Grilli, 1993).[28] Crises may enable policy reform, because they can change the relevant constellation of actors. In the pension reform arena, they tend to reinforce the "privatisation faction". Fiscal crises turn the Ministry of Finance into a potential actor, in the pension reform arena. More specifically, when pension financing goes into deficit, the resulting dependence on budgetary subsidies grant this likely advocate of the "new pension orthodoxy" an important stake in reforming old-age security (Müller, 1999). Furthermore, a persistent financial crisis may severely erode public confidence in the public pension systems, thus facilitating fundamental reform. Almost all the countries reviewed above experienced a sizeable fiscal deficit, and/or high pension expenditure prior to reform. Croatia's fiscal deficits were low, but public pension spending, and system dependency ratios, soared. Hungary and Bulgaria experienced grave economic crises, before embarking on pension privatisation. In Bulgaria, the need for fiscal restraint was heightened by the adoption of a currency board, shortly before preparations for pension reform began.

The cases of the Czech Republic and Slovenia show that there is a flip side to the economic factors, and considerations that potently pushed pension privatisation elsewhere. In both countries, policymakers were fully aware that pension privatisation would have resulted in substantial fiscal costs, in the short and medium-term, thus complicating future compliance with the Maastricht criteria. Particularly, in a context of high implicit pension debt, this concern may render Ministers of Finance

27. Yet, contrary to these high hopes, the Chilean evidence suggests that pension privatisation actually had a negative impact on national saving (Mesa-Lago, 1998).

28. Situations of perceived emergency can induce contending political groups to agree upon unpopular, painful measures and facilitate the destruction of political coalitions that had blocked reform, breaking a previously existing stalemate (Williamson, 1994). However, the "benefit of crises" hypothesis has not met with unanimity among scholars of the political economy of policy reform.

potentially ambivalent allies of the new pension orthodoxy.[29] Moreover, while the development of the local capital market was a frequently mentioned motive for pension privatisation elsewhere, policymakers in these two countries explicitly pointed to the nascent stage of Slovenia's capital market, and the crisis-ridden financial sector in the Czech Republic, when cautioning against radical pension privatisation. In Croatia and Bulgaria, similar concerns led policymakers to postpone, albeit not to abandon, the introduction of the mandatory funded tiers.

Yet another economic context factor needs to be considered. When external debt is high, governments tend to stress their general commitment to market-oriented reform. The announcement of pension privatisation can be interpreted as a "signalling" strategy (Rodrik, 1998), as rating agencies include radical pension reform, as a point in favour, in their country-risk assessments, despite its fiscal impact. Critical indebtedness also increases the likelihood of the involvement of the IFIs in the local pension reform arena (Brooks, 1998). Their leverage is partially determined by their stakes as important creditors in many transition countries. However, their impact is not limited to binding conditionalities, resulting from their own financial involvement. Rather, it is the general level of external indebtedness that matters, as the IMF and the World Bank "may signal that a developing country has embraced sound policies and hence boost its credibility" (Stiglitz, 1998, p. 27). When their recommendations are disregarded by local governments, alternative sources of market financing are often hard to obtain. As noted by Kay (1999), policymakers were well aware that financial, and/or technical support from the IFIs was only available for a pension reform that included a privatisation component.

Bulgaria and Poland were classified as severely indebted at the time of pension privatisation, while Hungary was characterised by moderate indebtedness (World Bank, 1996 and 2001*b*). The cases of the Czech Republic and Slovenia indicate that the leeway of the IFIs, as advocates of multi-pillar schemes, may be constrained by contextual factors. Slovenia and the Czech Republic are very advanced transition countries, characterised by a low level of external debt.[30] In this context, both the potential leverage by IFIs, and their interest in spending resources on the promotion of pension privatisation, is severely limited. Croatia's indebtedness was also classified as low, yet Croatia's political isolation under Tudjman still rendered the IFIs important international allies. Thus, the "global politics of attention" (Orenstein, 2001; Orenstein and Haas, 2002) needs careful differentiation.

The importance of reform design

It is widely observed that parametric reforms, although moderate in the light of paradigmatic alternatives, are politically sensitive. They easily allow the identification of individual losses, and are perceived as a mere cutback of acquired entitlements – without anything in exchange (Holzmann, 1994; Müller, 1999). The obstacles to parametric pension reform in the Czech Republic only highlight the potential that such reforms may hold, to engender sizeable blame. In several of the above country cases, reformers attached great importance to reform design, with a view to lowering the political

29. In this context, it is interesting to note that the IFIs have recently modified their stance on fiscal deficits stemming from a shift to funding. In the Hungarian case, the World Bank (1999*a*, p. 44) argued that "the transitional deficit is not a fiscal deficit in the usual sense", while the IMF (1998, p. 62) followed a similar line of reasoning with regard to Croatia.

30. As pointed out in World Bank (2001*a*, p. 13), the Czech Republic even has a net *creditor* position vis-à-vis the outside world. In turn, Slovenia is classified as high income and will soon graduate from World Bank financial and technical assistance altogether (World Bank, 2000*b*). International country ratings indicate that Slovenia and the Czech Republic currently enjoy the best evaluation of all transition countries in terms of investment risk and credit rating.

resistance to pension reform. The relevance of tactical sequencing, strategic bundling, packaging and compensation, has been stressed by scholars of the political economy of policy reform (Haggard and Webb, 1993; Sturzenegger and Tommasi, 1998).

The Hungarian and Polish reformers resorted to tactical packaging, when they distanced themselves from the Latin American models, and stressed the originality of local reform efforts (*e.g.* Rutkowski, 1998).[31] In spite of the obvious conceptual parallels, that indicate a *de facto* inclination towards the Latin American models, policymakers decided to avoid all reference to these precedents, as soon as they found out about the inconvenient connotations among the Central European public (Müller, 1999; Orenstein, 2000). To mitigate resistance to reform, reformers resorted to direct compensation, by granting compensatory pensions to those who switched to the newly established funded tier, even though, for fiscal reasons, acquired pension entitlements were rarely recognised completely. With the exceptions of Hungary and Croatia, where the new pension systems are truly universal, reformers opted for a strategy of exclusionary compensation, and division of potential opponents, by exempting powerful pressure groups from structural pension reform.[32]

Full or partial pension privatisation enables policymakers to hand out potentially attractive stakes to potential opponents, thus creating constituencies (Graham, 1997). "Shifting to a funded scheme … allows for arguments that all can win, thus abandoning intractable zero-sum games" (Holzmann, 1997, p. 3). In a number of countries, reformers granted trade unions the right to run their own pension funds, thus converting them into stakeholders of pension privatisation. In Bulgaria, the business interests of the trade unions, in the private pension industry, preceded plans to establish a mandatory funded tier, thus facilitating a broad consensus on partial pension privatisation. In contrast to this, neither the Czech nor the Slovene unions were interested in reaping economic benefits from setting up their own pension funds in a mandatory tier, contrary to a part of organised labour elsewhere. The Slovene unions were in close contact with their German counterparts, staunch opponents of pension privatisation. In the case of the Czech unions, their reluctance may be connected with the fact that their early involvement within the voluntary pension funds tier remained unsuccessful.

Polish policymakers intended to embark on strategic bundling, by linking enterprise privatisation with systemic pension reform. However, they eventually decided to use privatisation proceeds to cover transition costs, by supplying them to the state budget. While helping to solve the fiscal consequences of a partial shift to funding, this use of privatisation proceeds completely lacks visibility (Gesell-Schmidt *et al.*, 1999). In Bulgaria, reformers thought that private pension funds could transform privatisation vouchers into tangible benefits, but met with a lack of enthusiasm among private pension fund administrators, for converting vouchers into old-age pensions.

As stressed by Pierson (1994), the political costs of reform can be lowered, by increasing its complexity. In several East European countries, the reformers' strategy amounted to bundling up some unavoidable, yet politically sensitive, reforms of the public PAYG tier, with the more visible introduction of individual pension fund accounts (Holzmann, 2000). This "obfuscation strategy", in Pierson's terms (1994, p. 21), entails the potential to lower the visibility of the envisaged cutbacks and to draw public attention to the granting of individualised ownership claims. The introduction of the individual pension fund accounts tended to be perceived as the creation of a monitorable track record of

31. But cf. Müller (1998).

32. James and Brooks (2001) distinguish between four types of compensation: exclusionary compensation exempts powerful groups from reform, direct financial compensation tackles groups adversely affected, indirect and cross-compensation imply trading off one policy for another or linking reforms, and political compensation exchanges broader political rewards for support on a specific issue.

individual property rights over time, that the political system would be less likely to take away. In contrast to the unfavourable public perception of parametric reforms, the drawbacks related to pension privatisation are often easier to conceal (Müller, 1999).

In most East European countries, the scope and financing of transition costs – a major fiscal and distributional issue, when it comes to a shift to funding – were successfully shielded from public debate. Hence, the public perception of the strengths and weaknesses of pension privatisation, was biased towards its advantages, while the concomitant fiscal burdens were ignored. This asymmetry of perception may explain the observable fact, that policymakers have legislated structural pension reform in pre-electoral periods (*e.g.* in Hungary and Poland), contrary to the conventional notion, that retrenchment, as well as radical reforms, are unlikely to be tackled, when the hazards of accountability are high. This suggests that the perceived attractiveness of pension privatisation may outweigh its blame-generating potential, thereby differing markedly from the politico-economic potential of parametric reforms. However, the prospect of new privately run pension funds was received less enthusiastically, in countries where memories of fraudulent pyramid schemes, and failing banks, were fresh, such as Croatia and Bulgaria.

When it comes to sequencing, a fiscally motivated strategy was chosen in Croatia and Bulgaria, which started with a downsizing of the public scheme, and introduced a funded tier only three years later. However, as the different components of pension reform were legislated as parts of an overall package, and by the same government, an underlying bundling strategy can still be observed. Contrary to this, Polish policymakers resorted to deliberate unbundling in the legislative process, mainly driven by the political cycle. Pension privatisation was legislated by the outgoing government, while the restructuring of the public tier was left to the new government. Pension reform was then bundled up, with three other structural reforms, that were to come into force simultaneously. The latter turned out to be a very costly strategy. Pension reform preparations, most notably the information technology system, were not ready on time, but the reform "had to" start anyway, resulting in substantial implementation problems, that persist to the present day (Chlon-Dominczak, 2002). This example highlights the fact that the reformers' desire to exploit a political window of opportunity, to pass and implement pension privatisation, may clash with optimal reform preparations, and existing state capacities.

Concluding remarks

Unlike the bulk of pensions-related research, this paper did not discuss the desirability of alternative pension reform paths.[33] Instead, the author sought to explain how different pension reform choices came to be made in six post-socialist countries, by analysing the behaviour of individual, and collective, actors under economic, political and institutional constraints. While strongly encouraged by the IFIs, the radical paradigm change in old-age security was mainly advocated by Ministries of Finance, staffed with neo-liberally trained economists. Pension privatisation perfectly matched their overall efforts to decrease the role of the state. These important allies of the new pension orthodoxy often faced intra-government opposition from the Ministry of Labour, committed to the Bismarckian traditions. Partial pension privatisation became feasible, when powerful actors inclined towards pension privatisation – the Ministry of Finance and the World Bank – had stakes and leverage in the local reform process. By comparison, radical pension reform did not proceed, when the Welfare Ministry was the only relevant pension reform actor. Trade unions played a variety of roles: while staunchly defending the PAYG scheme in some countries, which they often helped to administer, through tripartite bodies, they turned into stakeholders of partial pension privatisation elsewhere. Most

33. For an evaluation of the recent pension reforms in Eastern Europe, see, *e.g.* Müller (2001*b*, 2002*b*).

notably, in Croatia and Poland, a seemingly successful defence of the *status quo* in old-age security in the courts backfired, leading to a shift to funding, as the alternative reform path, based on parametric changes, was effectively blocked. The cases analysed here indicate that, contrary to conventional wisdom in social policy research, far-reaching pension reform is possible, in a democratic context. They also show that there may be some potential for diversity in post-socialist pension reform, beyond the orthodoxy.

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Chapter 2

THE POLITICAL ECONOMY OF PENSION REFORM IN LITHUANIA OR WHY PENSION REFORM IN LITHUANIA HAS BEEN DEBATED FOR SO LONG?

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The pension reform of 1995 and debates on private pension provision

After regaining independence in 1991, Lithuania began to consider its own pension system. It did not seem feasible to continue with the Soviet pension law of 1956. At that time, all pensions were calculated according to the average wage during the last 12 months of work, with the amount of pension set simply as 50% of that. There was no link with contributions, although some were still paid, but to the general budget. Trade unions and local (municipal) governments administered pensions jointly.

In 1991, a separate social insurance budget was created, and in 1995, a package of laws on pensions came into force. Politically, it was essential to have a system which differed from the Soviet type, and which resembled the Western European systems. Thus, the Lithuanian pension system was reformed on the basis of the social insurance principles prevailing in modern societies.

A clear link between insurance records, the covered wage and contributions paid, and benefits, was established. A new pension formula was introduced, and all early retirement privileges were abolished. The retirement age, which used to be 55 years for women and 60 for men, was gradually increased to 60 years for women, and 62.5 for men. While the new system was based on social solidarity, and therefore implied substantial redistribution, it had a link also with the previous earnings of the insured. It was believed that the earnings-benefit link would ensure a strong initiative to participate in the system, and even encourage employees to press their employers to pay contributions in full. However, this did not prove to be the case, during the subsequent years. Due to strictly applied social insurance principles, the expanding informal sector, and forms of self-employment, coverage was constantly, and still is, shrinking.

The first debates, on the introduction of private pension provision in Lithuania, started as early as 1994, together with preparations for pension reform. However, the main concern of the Ministry of Social Security and Labour, and the government at that time, was the introduction of the new state social insurance pensions, payable from a separate budget, and financed from the contributions. For the creators of the new system, any private provision appeared simply as an add-on, and not an integral part of the reforms. At that time, the democratic labour party (previously the communists),

was ruling, and, naturally, the social-democratic views in support of preserving social insurance principles prevailed.

As part of the wave of reform of the pension system and, following the tradition of Western Europe, the major employer organisations expressed an interest in having their own savings vehicles, that is, employer-sponsored pension funds. However, there were no legal provisions to establish such funds, at that time. Under pressure from employers, the first group, with the task of drafting a law on supplementary pension insurance, was established, under the auspices of the Ministry, in the autumn of 1994. It was headed by a representative of the major employer organisation in Lithuania, the Industrialist Confederation.

After the general elections, in 1996, the conservative party, the Lithuanian Motherland Union, gained a majority in the parliament. Before the elections, the party had signed a memorandum of mutual collaboration, with the Industrialist Confederation, which imposed some obligations on the government, to consult employers about its decisions. This was the main reason why the drafting of the law, regarding the operation of a pension, fund took so long. The major employers attempted, very actively, to make pension savings a source of cheap money, for their enterprises. They drafted their own version of the law, on the supplementary non-government pension provision, and presented it to the Ministry of Social Security and Labour. The draft explicitly favoured the employers' role in private pension provision, and was very non-transparent.

At the same time, from the beginning of 1994, a private liberal oriented non-government organisation, the Lithuanian Free Market Institute (LFMI), started to advocate private pension provision. The Institute had a joint project with the US Hudson Institute, an element of which was to formulate proposals for the introduction of a funded component into the pension system, and to better inform the Lithuanian public about private provision, and pension reforms worldwide. The active promotion of these ideas had a crucial influence on the pension reform process in Lithuania, and the Free Market Institute became a very significant player.

In Lithuania, there was some awareness of pension reform in Chile at that time, but the information was very scarce, and contradictory. The liberals admired this reform, while the social democrats thought it was too exotic to be followed, and not applicable to a country aspiring to become a part of a unified Europe. It took ten years, following the Chilean pension reform, before some of its results could be analysed. The World Bank issued the famous book "Averting the Old Age Crisis" (1994). This was hotly debated among Lithuanian social policy experts, as well.

The World Bank played an active role, in formulating reform proposals, in Lithuania. In the autumn of 1994, the first World Bank conference, on supplementary, and so-called "non-government" (at that time the word "private" was avoided) pension provision, took place in Vilnius. Thus began a series of international events, which dealt with reform issues. World Bank experts participated, as speakers, in almost all of them. Clarification of the government's position, on private pension provision, became one of the conditionals for the structural adjustment loan. However, it should be acknowledged that the World Bank never really pressed the government to carry out a specified pension reform, along the lines discussed in "Averting the Old Age Crisis".

The view, amongst the Lithuanian public, was that the advanced European countries had supplementary private pension provision which, one way or another, made the living of Western European retirees prosperous, and financially stable. This public opinion pressured social policy makers to search for ways of adapting European models to the Lithuanian environment. The model advocated by the World Bank (mandatory second pillar defined contribution plans), was considered appropriate only for third world countries, and not for Lithuania. The World Bank involvement, in

advocating this route, was regarded as a self-interested action. This opinion can still be encountered, in Lithuania.

However, in trying to adopt the desired Western Europe pension model, major legal problems arose. In contrast to the employers' approach, the Lithuanian Free Market Institute advocated that, in order to have a transparent and safe system, a separate legal entity for pension accumulation was needed. The Institute was successful at publicising the issue, and in persuading the general public that it would be dangerous to follow the employers' approach. However, no type of legal entity could be established, within the Lithuanian legal system, that would have been an appropriate vehicle, for such savings. A long learning, and debating, process began.

At the beginning of 1996, the LFMI presented its own draft proposal on pension funds, based on the co-operative approach. This choice was heavily influenced by the experience of Hungary, which already had voluntary pension funds in operation. In fact, the same expert, who was involved in the creation of the Hungarian system, advised Lithuania.

The Ministry of Social Security and Labour was not very active in this process; it focused on increases to current benefits. In 1995, it seemed too early to make any adjustments to the recently reformed system. In 1997, due to unjustified increases in social spending, the deficit of the social insurance fund increased, which was a major preoccupation for the Ministry. Social security experts, who led the reform process at the Ministry, were very sceptical about private pension provision. Thus, it was no surprise that the Ministry took a passive position on this issue, and the most active private pension promoters were non-government organisations, who had no real power to change the system.

This led to the situation, where the Ministry eventually faced a dilemma, since two drafts on private pension funds were presented, at the same time. The LFMI draft was much more transparent, and took into account the interests of participants of pension funds, while the Industrialist Confederation draft law clearly favoured the interests of employers. The memorandum bound the Ministry not to reject the industrialist's approach. On the other hand, the Ministry clearly understood its responsibility for protecting participants' interests.

The Ministry took no decision and, as is usual in such situations, tried to create a consensus, and established another working group, consisting of the parties involved, to "merge" the two drafts. Since these drafts were based on completely different approaches, and represented different interests, the work took a long time. More than three years were spent, in vain. Due to this passivity, the issue became embarrassing to the Ministry, as it was criticised by both sides. The Industrialist Confederation bought large spaces, in the daily newspapers, for articles describing the inefficiency of the state pension system, while the Free Market Institute arranged international conferences, advocating the advantages of funded pensions. and claiming that the Ministry was doing nothing.

At that time, the Ministry of Finance was not involved in the process. While the Ministry of Social Security and Labour felt itself lacking in competence in this new area, and considered that this was more of a financial, than a social, issue, it could not abandon the matter, since, politically, pension reform was clearly its responsibility.

During the debates, the Free Market Institute produced a new version of the draft law on pension funds. This was based on joint stock company law, and pension funds were to be assumed to be another kind of separate, and open, profit-making financial institution, where participants would be clients. In 1999, the Ministry of Social Security and Labour, perhaps feeling stuck with the issue, finally handed the drafting of the private pension provisions over to the Ministry of Finance. It realised that it was much more of a financial, than a social, issue, involving the possibility that people who had

contributed to funds, might reclaim their money, and that it was too great a responsibility to decide to support one or other of the draft laws.

The Ministry of Finance took the second draft of the LFMI, as a background paper. A new working group was created, from almost the same people as the previous group. The employers did not participate further, as they understood that there were no prospects of realising their interests, in the model likely to emerge. However, the Ministry of Finance also was very conscious of potential problems. Lithuania had bad memories of the bankruptcy of major banks in late 1995. In order to prevent any emergencies with the pension funds, which could be politically even more dangerous, the draft law on pension funds was written in a very restrictive manner, and contained provisions unusual for voluntary savings.

Finally, a special law, regulating pension funds, was adopted in 1999. Savings in pension funds were offered favourable income tax treatment – up to 25% of wages could be exempt from personal income and profit taxes, if diverted to accounts in a pension fund. However, the benefits were supposed to be taxed.

Employers were no longer interested in the issue, as there was no reduction in social security contributions. Trade unions supported the proposal, since they expected that additional pension savings would result in benefits, in line with European standards. However, their position was a little contradictory. Trade unions relied heavily on the employers' participation, but opposed the reduction in social insurance contributions, which would have been largely enjoyed by employers.

Interestingly, the World Bank regarded the Lithuanian Law on Pension Funds, as one of the most clear-cut, and well written. It was even proposed to duplicate it in other transition countries.

The Law on Pension Funds

Since the 1 January 2000, the Law on Pension Funds, which provides for the establishment of private fully funded pension funds, has been in force. These funds operate on the basis of contributions accumulated in individual accounts, and are managed privately. Every person, local or foreign, can establish such a fund, if it fulfils the licensing requirements, set out by law. Supervision of private pension funds, as of other participants in the capital markets, is handed over to the Securities Commission.

Pension funds are open, and they operate as financial institutions. Every pension fund can have several separate pension schemes, which differ by investment strategy, and conditions of participation. Employers can establish their own, closed, pension programme, within a particular pension fund. There are no occupational, employer provided, pension schemes, as separate legal institutions.

However, so far, no single pension fund has been set up in Lithuania. At least three reasons have caused this situation: the rigid regulation established in the law, the small Lithuanian market for supplementary provision, and an unequal tax regime. There was a requirement to provide participants in a pension scheme, with a minimum annual investment return. In early 2001, this requirement was repealed, and some other improvements made. However, there is too small a market for supplementary pension insurance in Lithuania. The contribution rate in the mandatory system, is high (34%), wages are low and, practically speaking, there is no spare income to pay for supplementary insurance. In addition, benefits from pension funds are treated less favourably, by the tax system, than other life insurance products.

Contributions to individual accounts in private pension funds are tax-exempt, up to 25% of annual personal income. Employers can deduct contributions on behalf of employees, up to the same amount from profits. Benefits from pension funds are taxable, on the same basis as other income. However, life insurance products enjoy non-taxable contributions, up to a reasonable ceiling, and benefits are fully non-taxable. Not surprisingly, the life insurance market is growing rapidly, in Lithuania, while there are almost no prospects of selling pension fund products.

Radical pension reform proposal

The establishment of voluntary pension funds was regarded as a test, for the later introduction of mandatory private savings for old age. However, this did not happen. For many reasons, Lithuania has not seen the proposed model in operation.

Social security experts, as well as politicians, started to discuss the necessity of introducing mandatory provision, or to reform pensions again. The first attempt, to consider further reform, was made by a group of social security experts, brought together by the Ministry of Social Security and Labour, in 1999. The group presented the Ministry with proposals for pension reform, which set out the possible pros and cons of a partial privatisation of pension provision.

However, the Ministry was not really interested in undertaking a radical reform, as it was clearly realised that there was no money to cover the transition costs. The right-wing Conservative Party won the elections in 1996, by promising to restore the savings, lost in Soviet banks, during the turmoil created by regaining Lithuania's independence, and by introducing a national currency. This restoration was financed by the assets obtained from privatisation. Starting in 1997, some groups in the population, mainly the electorate of conservatives, had already received their savings.

The same source of money was pin-pointed as the possible source for covering the transition costs of pension reform. Consequently, consideration of second pillar pension reform proposals was merely a reaction by the Ministry, to take advantage of the philosophy of the right-wing party, rather than an intentional plan.

In the autumn of 1999, after government crises, the new government, of the same ruling Conservative Party, came into power. It was a liberal administration, and initiated several reforms in different fields. This government was actually forced into these reforms, as Lithuanian public finances were in a critical shape, at that time, and the state started to encounter serious difficulties in borrowing on the international market. The previous government had pursued thriftless budgetary policies, with increasing subsidies, social spending, and government investment. In addition, in 1999, Lithuania finally felt the consequences of the Russian financial crisis. The new government introduced very restrictive fiscal policies, and the savings restitution programme was stopped.

Despite the poor state of public finances, or maybe because of this, the government started to talk about pension reform, in the sense of the introduction of second pillar savings for old age. The main driving force, as for other reforms, was not a particular ministry, but the Prime Minister's office. However, there was only one year left, before the general election in 2000. Any serious attempt to implement the reform was unrealistic. Therefore, the government restricted itself to the conceptual preparation of the issue.

In April 2000, after the new working group finished its work, the Lithuanian government adopted the Pension Reform Concept, which entailed the creation of the so-called three pillar pension system. The concept outlined the main problems of the Lithuanian pension system, and clearly proposed to

introduce a mandatory saving scheme, by splitting the payment of the existing social insurance contribution.

The idea had almost no opponents from any political party, or from the social partners, but the question of transition costs was repeatedly raised. Following the Polish example, Lithuania decided to research pension reform, exploring possible reform scenarios, and implementation options. This was the White Paper on Pension Reform. The government set up a special working group, to prepare the white paper, consisting of Lithuanian social security and finance experts. from both state and private institutions. The World Bank supported the idea as well, but the local experts provided the main input.

Following the concept, the Pension Reform White Paper analysed in depth the possible ways in which pension reform could be implemented in Lithuania, formulated concrete proposals for organising the second mandatory savings pillar, and modelled the pension system's development, according to different scenarios. The World Bank model, Pension Reform Options Simulation Toolkit, was used for calculations. The paper was presented to the government, in October 2000.

Approaching the general election, the government, and especially the reform promoters, started to think about how to ensure the success of the implementation of the proposals. It was self-evident that the ruling Conservative Party would not win the elections, and that the government would change. In searching for political support from all parties, a pension reform steering committee was set up. However, only small parties unlikely to be in power, and the social partners, joined it. Interestingly, both employers, and trade unions, clearly supported the idea of introducing the second pillar, which was not the case, at a later stage.

In the autumn of 2000, Lithuania held general elections, and the new coalition government was formed, with liberals and social-liberals. Not surprisingly, the new government committed itself strongly to preparing, and implementing, pension reform. An action plan was adopted, which set out the four main areas of preparation for the reform: review, and amendments to the law, to create an appropriate legal basis for the reformed system, preparation of the administrative system, creation of a supervisory system for pension funds and launching a public information campaign. As the first step, the Law on the Pension System Reform was drafted and presented to the parliament. The responsibility for co-ordinating the reform was given to the Ministry of Social Security and Labour, while high ranking representatives from other state institutions, such as the Securities Commission, and the Ministry of Finance, also participated.

The government's pension reform proposal was as follows: from 1 January 2003, a mandatory defined contribution, second pillar pension scheme was to be introduced. It was to be financed by a diversion of 5% of the existing social insurance contributions, for insured persons under 40 years of age. Insured persons aged between 40 and 50 could choose whether, or not, to participate in the second pillar. The contribution rate, for the funded pension, is the same for all age groups, that is 5%. The total social insurance contribution rate will not be increased. Those aged over 50, will stay with the public pension pillar.

The first pillar is to be untouched by this reform. As the pension reform of 1995, which introduced social insurance pensions, had already made parametric reform to the first pillar, there was no need to change it significantly. The retirement age is already being increased, step-by-step; all early pension provisions are to be repealed, and indexation rules have been adopted. In 2001, other steps, to limit social security expenses, were taken. These were: the reduction in benefits to working pensioners, the introduction of stricter rules for sickness and maternity leave insurance, and accelerating the increase in the retirement age. These changes were received very painfully, and the possibility of any further parametric changes was felt to be exhausted. The only change to be made, in

relation to the introduction of the second pillar, is the proposed reduction in the first pillar social insurance pension, for those who switch to the new pension system, proportionally with contributions paid to the first pillar.

Mandatory accumulation is to be achieved by the same type of open pension fund as stipulated in the Law on Pension Funds. However, some stricter requirements may be applied. For example, a relative rate of return will be prescribed. The purchase of life annuities is mandatory, after reaching retirement age. The life insurance companies, who do not provide pension funds, will provide these annuities. The supervision of mandatory pension funds will probably be largely undertaken by the Securities Commission, while the Ministry of Social Security and Labour may also play a role.

The estimated cost of transition to the multi-pillar pension system is about 1% of GDP, if two-thirds of the insured aged between 40 and 50 switch to the new system. It was proposed to finance the contribution gap occurring in the social insurance budget, by the inflows from privatisation assets, a special-purpose World Bank loan, and from the state budget.

The pension reform proposal actually competes with the so-called savings restitution programme, which is supposed to use also the proceeds of privatisation. The savings restitution programme was executed in 1998-1999, step-by-step, for different groups of the population. In 2000, the programme was frozen for two years. It is in operation again now, but in very limited way.

Putting the pension reform proposal on the agenda, in 2001, raised the issue of what to do with the savings restitution programme, which was an obligation of the previous government. During the election campaign, the majority of political parties expressed views that were hostile to it. However, having become the ruling coalition, neither liberals nor social-liberals were so definite. It became a very politically sensitive issue, as savings were restored for some groups of the population, and were promised later for others. This programme was one of the main reasons for the Conservative Party's victory in 1996.

The government's pension reform proposal was presented to the parliament, in late May 2001. It led to heated debates. These were mainly related to the ways of financing the reform, and how to fulfil other state obligations, such as the completion of the savings restitution programme, and co-financing EU accession programmes. In fact, the avoidance of setting out a clear position on the savings restitution programme became one of the political obstacles to reaching consensus on the reform implementation.

In July 2001, the coalition of liberals and social-liberals fell, and a new coalition, of social democrats and social-liberals, formed the new government. Social democrats questioned whether it was necessary to introduce mandatory private savings into the state pension system, and to partially privatise the system. Some of their key social experts proposed to offer better initiatives for voluntary provision, and called them pension reform. Lithuania was returned to the debates on "voluntary or mandatory private pension provision" of 1998-1999. A new working group was created, but it produced no results, as all the parties involved refused to compromise their opinions.

In this disagreement, employers backed voluntary provision. Such a position is understandable as, only in voluntary private pensions, could they expect to have their own pension funds, and substantial tax relief and reductions in social contributions. The position of the trade unions was not so clear, perhaps due to fact that the organisation of the trade unions was very fragmented, or because they previously actively supported the idea of private pensions. It was not spelled out whether they were talking about the second or the third pillar, when talking about the reform.

The Ministry of Finance was actively supporting, but not leading, the process. The main actor was the Ministry of Social Security and Labour. The parliament ordered a presentation of the full picture of state obligations, and the prospects of fulfilling them, in the coming ten years. The Ministry of Finance voiced the opinion that it would be possible to proceed further with the savings restitution programme, and to implement the pension reform. However, its scope should be reduced somewhat.

The Ministry of Social Security and Labour adjusted the reform proposal, by reducing the age group for mandatory participation in the new system, from 40 years to 30, and postponing the starting date of the reform, for one year. However, this did not stop the "voluntary-mandatory" debates.

Opinion in parliament was not unanimous. It was symptomatic of their respective interests, that the social affairs committee supported voluntary provision very actively, while the budgetary committee stood for mandatory private pensions. These debates showed that it was not only financial concerns that differed, but that there were clear ideological differences, as well. People with clearly formulated social democratic views disliked changing the social security system itself, because they feared it would be privatised, and therefore weakened. On the other hand, it was felt that voluntary provision actually meant that contributions for social security would be increased, as people, or their employers, would pay additional amounts. This seemed to be preferable, even if the subsidies for the third pillar would be about the same size those to cover the gaps left after the introduction of the small second pillar.

Eventually, parliament supported the opinion of the social affairs committee. However, this was achieved by very formal procedures, and not by consensus. The government, that is the Ministry of Social Security and Labour, has to present the version of the draft law supporting the creation of a strong third pillar provision, for old age savings. It was expected that this pillar would be implemented from January 2003. Preparations for the second pillar provision, if any, will be postponed for an indeterminate period.

The year 2004 will also see general elections for the new parliament. It may well be that the issue of radical pension reform will be raised again, as no consensus upon this issue has been found so far.

ANNEX
THE STARTING POINT AND RATIONALE FOR REFORM

Demographic forecasts of the Lithuanian population show some favourable periods for the pension system in the years ahead. Starting in 2004, and continuing up to 2010, the ratio of the working age population to retirees will improve, due to the large cohort of workers born during the period when fertility rates were high in the 1960s and 1970s, and who will be in labour market, and the low numbers of persons born during the Second World War, who will reach retirement age. It is anticipated that for several years, the pension system could be in surplus.

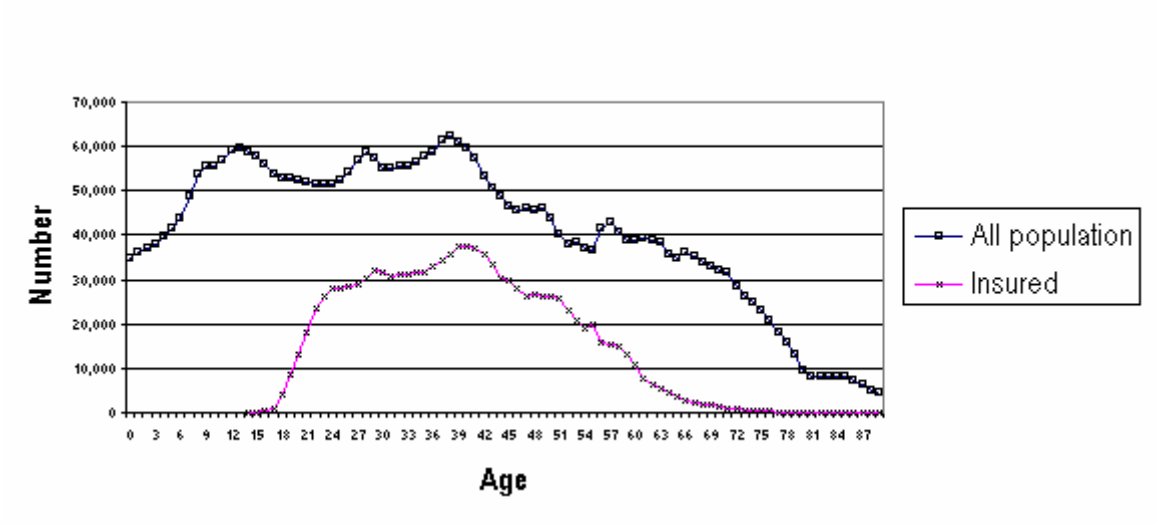
However, this improvement will not last long. From 2015, the pension system balance will become negative. It will experience a deficit of as much as 1.5% of GDP in 2055. This means the lack of one-fifth of the inflows to the system per year, as pensions currently consume about 7.5% of GDP. Pensions are quite low (the average replacement rate is 34%), so it is very likely that the surpluses will be spent to raise benefit levels. This, in turn, means that the future deficits will be even higher.

The question arises, as to whether it is possible to use the surpluses predicted, to cover future deficits in the system. It would be wise to conserve these monies. However, it is unlikely that a government could avoid spending the state's financial reserves according to political pressures (for example, raising pension expenditures). In practical terms, there is no other way of predicting the amount of money, and ensuring it is fully earmarked for pensions, than to channel it into individual accounts, where it will be untouched up to a person's retirement. This is the most serious argument for the introduction of mandatory, individual, savings accounts, for old age.

The temporary surpluses in the pay-as-you-go (PAYG) system could cover part of the transition costs, due to the transfer of part of the contributions into individual savings. Later on, when the deficits rise, it will be more difficult to introduce pension reform. Such individual reserves would diminish state social security liabilities, and ease the burden of old age provision, for future generations. A balance should be found between the interests of current pensioners, who expect benefit increases, and the expectations of current workers (contribution payers), of receiving at least modest pensions, when they retire.

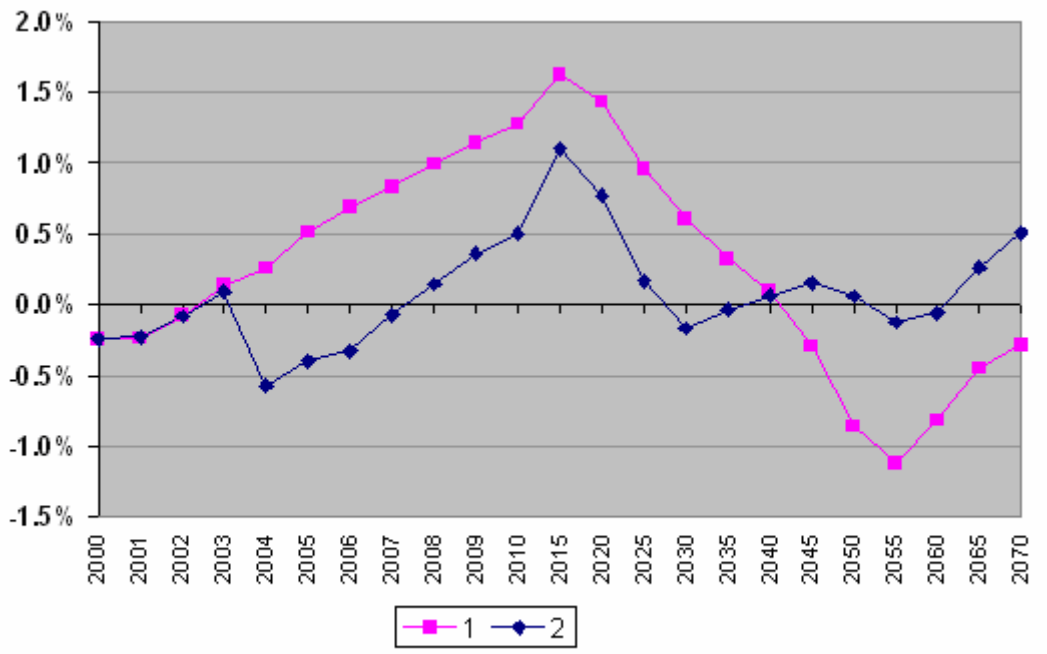
Figures 2.1 and 2.2 illustrate the contemporary demographic profile of the Lithuanian population, and the possible balance of the future social insurance pension system, under two scenarios.

Figure 2.1. Total population and number of insured by state social insurance by age groups in 2000



Source: Author for the OECD.

Figure 2.2. The balance of the state social insurance fund (% of GDP)



Note: Line 1 shows the balance of the state social insurance fund, if no pension reform is undertaken but the retirement age is increased to 65 for both women and men. Line 2 shows social insurance data if pension reform is launched in 2004 and insured persons up to 40 years of age are contributing 5% of their current wages.

Source: Author for the OECD.

Chapter 3

THE PENSION SYSTEM IN THE SLOVAK REPUBLIC AT THE THRESHOLD OF REFORM

by
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The current pension system in the Slovak Republic is mainly characterised by the solidarity principle, and public redistribution, and by suppression of individual motivation and responsibility. The system is pay-as-you-go (PAYG) financed (supplemented by state budget financing), and has a strong public component, administered by the Social Insurance Agency (SIA).[1] Private pension schemes are not yet well developed, although certain conditions have already been created for the operation of private supplementary schemes.

The public PAYG pension system in the Slovak Republic

Main characteristics

The current public pension system fully, or partially, fulfills the functions of providing old-age pensions, and income support, in old age, during sickness and for disability (both physical and mental), and in the event of the death of a member of the family. The main resources financing these systemic public pension benefits, in Slovakia, consist of mandatory pension insurance contributions. Employers are required to pay 21.6%, and employees 6.4%, of gross nominal wages to the pension fund of the SIA. The self-employed pay contributions of 28%. Contributions are paid from the state budget, in respect of secondary school and university students, persons caring for a child or a close relative, persons drawing a disability pension, or those doing their basic military service, where the incomes of such persons do not exceed the amount of the minimum assessment base. The National Labour Office pays contributions to the SIA in respect of persons receiving unemployment benefits. The problem, however, is that there is no clear determination of the level of the state contributions for these persons, or a mechanism for their calculation. The actual level of these contributions has changed from year to year, depending upon what modifications have been made to the calculation base, by the state budget (Figure 3.1).

In fact, although the contributions made by employers, workers and the government are officially called insurance premiums, they actually represent a form of payroll tax. In the following text, they are referred to as either contributions, or pension insurance contributions.

1. The Social Insurance Agency was established by a special law on 1 January 1995. It is a public institution and part of the government public service.

Parameters of the pension system

The Social Insurance Agency mainly pays a range of pensions:

- Old-age pensions and proportionate old-age pensions.
- Disability pensions and partial disability pensions.
- Special retirement pensions for soldiers, policemen, etc.
- Widows' and widowers' pensions.
- Orphans' pensions.

The SIA also provides other benefits:

- Social pension.
- Wife's pension.
- An increase of pension being the sole source of income.

Resources, for financing these additional non-systemic benefits, are transferred from the state budget.

Old-age pensions represent the most important component of all pension expenditures (Figure 3.2). The retirement age, for the right to a full old-age pension, is different for men and women. While there is currently a standard retirement age for men of 60 years, for women the retirement age varies from 53 to 57 years, according to the number of children they have had.

The current system of old-age pensions has only a limited relation to the actual level of wages, prior to retirement. This calculation is based on earnings up to the level of SKK 10 000, and does not take into consideration earnings above this limit. Pensions paid under the current system are tax-free. Relative losers in the current PAYG system are, therefore, mainly, people with higher incomes, between SKK 10 000 and SKK 32 000 (this latter amount is the current maximum contribution calculation base). The higher the earnings above the SKK 10 000 limit, the larger the fall in income on retirement. The unfair equalisation of pensions, and redistribution of resources, can best be demonstrated by the following comparison. While a person with a contribution calculation base (gross income) of SKK 10 000, and corresponding pension insurance contributions equal to 41.6% of his/her net income, received a pension in 2001 corresponding to 88.8% of his/her net income, a person with a gross income of SKK 32 000, and who had paid 46.4% of his/her net income to the system, would be entitled to the same pension, which, in his/her case, corresponds to only 30.9% of his/her net income.[2]

The average old-age pension in 2001, in real terms, corresponded roughly to only 84% of the pension in 1989, the last pre-transition year. On the other hand, thanks to annual indexation, average old-age pensions remained at about the same proportion of average net wages, throughout the last seven years, moving in the relatively narrow range of 57.7 to 59.4% (Figure 3.3) of average net wages. Changes in the living standards of pensioners have thus mirrored the changes in the living standards of average employees.[3] A seemingly paradoxical situation occurred in 2000, when the pension/wage ratio decreased by one percentage point, despite the growth of old-age pensions by 10.3%. This was caused

2. MESA 10 (2002, p. 13).

3. MESA 10 (2002, p. 11).

by a reduction in income tax, and the consequent substantial increase in average nominal wages. The average old-age pension also has a relatively high real purchasing power, when compared with other V4 countries (Figure 3.4).

Financial aspects of the current pension system

Revenues

The collection of contributions for public pensions (in 2000 accounting for 7.5% of GDP) is insufficient to fund public pension expenditures. Even more marked, is that the increase in the collected pension insurance contributions has been gradually falling, from a 24.5% annual increase in 1995, to only 0.4% in 1999. The year 2000 saw some improvement, with a 7.1% increase in contributions collected. Although the nominal increase in contributions collected in 2000 was 17.8%, it has to be adjusted to make it comparable with previous years.[4] This improvement was due, exclusively, to the collection of contributions from the economically active population, who provided 93% of all contributions collected in 2000, with three-quarters paid by employers, the rest being paid by employees. The volume of contributions paid by the state for selected social groups decreased, and the volume of contributions paid by the National Labour Bureau for the registered unemployed stagnated.

The inadequate collection of public pension insurance contributions, in Slovakia, is influenced mainly by the following inter-related factors:

- The low social contribution (and tax) base, accompanied by general economic problems, the inadequate economic performance of enterprises (except in 2000, when an improvement was achieved) and poor labour productivity, which has contributed to the decline in the year-on-year increase in gross nominal wages (from 14.3% in 1995 to 6.5% in 2000, with a moderate improvement to 8.2% in 2001).

- The excessive total social contribution (50.8% of gross nominal wages) and tax burden,[5] which in turn has a negative influence on the social contribution base.

- The growing rate of unemployment (from 13.1% in 1995, to 18.6% in 2000, and 19.2% in 2001); and other factors, for example, reduced payments from the state budget in respect of the economically non-active population (as the result of changes in the percentage of the assessment base, for insurance payments, payable by the state).[6]

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4. In 2000, the adjustment of collection of pension insurance contributions corresponds with government transfers to the SIA of SKK 6.05 billion. These payments followed from sales of shares in Československá obchodná banka (CSOB) and Slovenské telekomunikácie, Slovak Telecom (ST), and they were intended to pay off the SIA's claims vis-à-vis Slovak Railways (ZSR) and state health institutions.

5. The contribution rates for pension, sickness, unemployment and health insurance payable by employers and employees on gross nominal wages exceed the rates in the neighbouring transition countries – for example, in the Czech Republic by 3.3% and in Hungary by 9.8%. Moreover, the burden on employers and employees from social contribution liabilities in Slovakia is 26.0% higher than the average rate in OECD member countries.

6. For 1994, the National Council (NCSR) approved payments from the state budget at 26.5% of 90% of the calculation base of the minimum wage (SKK 2 450) to the SIA, in respect of the economically non-active population. However, in 1999, the NCSR approved payment of only 27.5% of 15% of the

The development of the collection of pension insurance contributions, mainly from the economically active population, is strongly determined by labour productivity, and the performance of enterprises, which in turn determine the real ability of economic agents to generate resources (value added) for wage growth, since the volume of wages represents the actual contribution base. Low annual labour productivity growth rates have not yet created conditions for long-term improvements in the economic performance of enterprises.[7] The downward trend in the dynamics of collection of pension insurance contributions, up to 2000, was mainly the result of the overall financial problems of enterprises, leading to decreasing year-on-year growth of gross nominal wages. The improved economic performance of enterprises, in 2000 and 2001, had direct positive effects on the improved collection of contributions, from the economically active population and, consequently, also, on the overall volume of contributions.[8]

The collection of pension insurance contributions is also negatively affected by the lack of financial discipline of enterprises. Intentional manipulation of the level of the calculation base, and even open unwillingness to pay social contributions, are mainly the result of poor government enforcement procedures, for collection of contributions, in the period 1995 to 1998, and of unethical business practices. A consequence, was the growth of claims by the pension fund of the SIA, to SKK 40 billion (4.5% of GDP) by the end of 2000 (Figure 3.5).[9]

Expenditures

Expenditure on public pension benefits increased significantly between 1995 and 2000 (usually, by more than public pension revenues). Increased spending on pensions, and requirements for pension benefits, were determined mainly by:

- Unfavourable demographic developments, particularly the increase in the number of people over labour force age, and the rise in their share of the total population, from 17.5% in 1995 to 18.0% in 1999 (according to projections by the Ministry of Labour, this proportion will increase to 26.4% by 2025). These developments have been coupled with increasing life expectancy, in general, and the anticipation of rising life expectancy for citizens of retirement age.[10] Unfavourable demographic developments will probably be further complicated in the coming 10 years, due to the arrival of new pensioners born in the boom years after World War II. Unless there are adjustments to the retirement age, the number of new pensioners retiring each year will gradually increase, from 51 600 in 2001, to 75 000 in 2011.[11]

- Legally binding increases in pensions, which must occur when average nominal wages in the economy have grown by 5%, and/or living costs, measured by the CPI, have increased by 10%. However, the existing legislation does not specify the amount by

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assessment base of SKK 2 700, though for 2001, NCSR approved payments from the state budget at 28% of 100% of SKK 2 400.

7. Real labour productivity growth declined from 6.3% in 1997 to 1.8% in 2001.

8. MESA 10 (2002, p. 9).

9. MESA 10 (2002, p. 10).

10. There is statistical evidence (on the basis of tables of deaths for 1998, SOSR) that in Slovakia the expectation of life for males of retirement age (60 by law) is, on average, 15.7 years and for females, (57 by law), 22.8 years.

11. MESA 10 (2002, p. 15).

which pensions are to be increased. The lack of a specific calculation formula creates room for irresponsible proposals, or decisions by the Cabinet, which has the responsibility for proposing a particular percentage increase. The same is even more likely to be true, of decisions relating to this matter made by the parliament, which has the final say about the increases. Decisions about increases may be made without a requirement that they reflect the limitations of the SIA budget, and may, thus, adversely affect the finances of the pension system.

– Deterioration in relevant socio-economic factors, mainly the rate of unemployment, and the net income of households, low savings of pensioners, and political agreement in parliament, on the rate of indexation of pension benefits.

Projected demographic developments, in general, low retirement ages, and the anticipated increases in currently low average old-age pensions, are significant risks, that may lead to increased public pension expenditures, in the future.

Financial imbalance of the public pension system – the need for change

The consequences of the tension, between insufficient collection of public pension revenues from contributions, and the growing requirements for public expenditure on pension benefits, include:

– The current deteriorating economic performance of the pension system (until 1997, this steadily worsened). In 1999, the deficit stood at SKK 5.9 billion, and at SKK 3.3 billion in 2000[12] (or even at SKK 9.4 billion, without special government transfers) (see Footnote 5).

– The probable further deterioration in the economic performance of the pension system. If the situation continues unchanged, future annual increases in the deficit in the pension system are expected to continue, reaching an estimated yearly deficit of SKK 44.5 billion in 2030,[13] with a potential impact on the accumulation of excessive implicit debt by the system. According to the calculations of the Ministry of Labour, over a 60-year time horizon, the present value of this implicit debt would reach SKK 1 270 billion in constant prices (190.2% of GDP in 2000) (Figure 3.6).[14]

The main problems (and potential risks), of the current public pension system, in Slovakia, result mainly from:

– The factors already noted, that cause the insufficient collection of insurance contributions, and the factors causing increasing requirements for pension expenditures, which aggravate the rising financial imbalance.

12. On the other hand, only systemic benefits are financed from pension insurance contributions, while non-systemic benefits (SKK 1.6 billion in 2000) are financed from the state budget (mainly from taxes). Therefore, the official balance of the public pension insurance fund corresponds to a deficit of SKK 1.7 billion in 2000 (without any adjustments).

13. According to the calculations of the Ministry of Labour, using a modelling approach: *The Concept of Social Insurance Reform in the Slovak Republic*, Ministry of Labour (2000).

14. *The Concept of Social Insurance Reform*, Ministry of Labour (2000).

- The falling ratio of pension contributors to pension beneficiaries, increasing the dependency ratio of pensioners, upon economically active taxpayers. The dependency ratio has gone up in Slovakia from 57.2%, in respect of all pensioners (or 37% for old-age pensioners) in 1997, to 63.6% for all pensioners (and 41.8% for old-age pensioners) in 1999.[15]

- Basic systemic distortions, mainly the predominant public and mandatory component of the system, and the PAYG financing, which does not stimulate economic growth, and individual savings (with a weak link between contributions, and pension benefits, etc.).

- Other distortions in the system (the short period of insurance, resulting from the low pension age, the different pension ages for men and women, the existence of non-systemic benefits, etc.).

In addition to the above-mentioned problems, the current PAYG pension system is unfair, and non-motivating. An elementary shortcoming, is that there is almost no relation between the length of participation in the system, and the volume of contributions paid, on the one hand, and the level of pension received, on the other. A negative result, is a distorted replacement rate, which is highly discriminatory, mainly against people with working life earnings, corresponding to the range of one, to three, times the average salary.

Recent efforts to deal with the problems, included a moderate increase in the contribution rate, by 0.5% in 2000. Another controversial step, is the proposed increase in the maximum contribution calculation base, from the current SKK 32 000, to 3.25 times the average wage in the economy (in 2002; this would mean an increase in the maximum contribution base, from SKK 32 000 to SKK 40 200, *i.e.* by 26%). Unless other parameters of the system are changed, any efforts to ensure, at least, the stability of pension payments, will inevitably include further increases in the contribution rate.

The current pension system in Slovakia, therefore, requires a systemic change – mainly through shifting the weight onto capital financing and individual accounts, with an emphasis on creating conditions conducive to a more extensive use of voluntary complementary, and individual private pension insurance schemes. Some of the conditions necessary, for the operation of private pension funds in Slovakia, have already been established, and several conditions are included in the government's concept of social insurance reform.

Private pension funds in the Slovak Republic

The system of supplementary pension schemes (SPS), which represents a Slovak version of private pension funds, was introduced in 1996. According to the legislation in force from 1996, until the end of 2000, the system was only open to employees of those enterprises that concluded agreements with a supplementary pension insurance company (SPIC). The system was not available to employees of organisations funded by the state budget, nor to the self-employed.

Under such agreements, both the employee, and the employer, paid insurance premiums. The contributions of the employee were tax-deductible, in full, and those of the employer were tax-deductible, up to 3% of the nominal value of the wages of the insured persons.

15. According to the projections of MLSAF, the dependency ratio of pensioners to contributors could deteriorate from 75.1% in 1999 to 127.4% in 2025, *The Concept of Social Insurance Reform*, MLSAF (2000).

At the beginning of 2001, amendments to the relevant legislation removed some discrimination within the SPIC system, and made it available to a much wider range of clients. The system is now open to all employees, including the employees of organisations funded by the state budget, although they can still face budgetary limitations, regarding benefits arising from the contribution of their employer. On the other hand, the Public Service Act, adopted at the end of 2001, creates conditions for collective bargaining. The system has also been opened to the self-employed. However, it is still not available to the security forces (the military and the police). Simultaneously, incentives for participation in the system were enhanced at the beginning of 2001, through the reduction of withholding income tax on SPS benefits, from 15 to 10%. On the other hand, a limit was introduced for income tax-deductible insurance premiums, for employees and the self-employed (up to SKK 24 000 a year, or 10% of gross income). Following these legislative changes, and better promotion of the SPIC, the number of participants in the system grew by more than 50%.[16]

Contributions, and benefits, in a SPIC, are based on Defined Contribution Plans. The level of benefits depends on the contributions and the share of the individual beneficiary in the income generated by the SPIC. According to Slovak legislation, a supplementary pension insurance company is a legal person with a special licence established by an employer, an association of employers, trade unions, or a combination of these subjects, exclusively in order to provide supplementary pension insurance. Establishment of a SPIC is subject to a licence approved by the Ministries of Finance and Labour, and finally granted by the government. If the licence is granted, the SPIC is registered in the special registry of the Ministry of Labour. An important part of the request for a licence, as well as for its entry into the registry, is the identification of a depository bank. Such a bank must have its headquarters in the Slovak Republic and hold a licence from the Ministry of Finance.

The highest body of a SPIC is the board of directors. The board consists of representatives of employers, insured employees/self-employed individuals, and eventually also of pension beneficiaries.

The materials necessary to obtain permission for the operation of a SPIC also include a financial plan (for 1 year) and a long-term financial plan (five years). The plans, including any adjustments and modifications, must be submitted to the Ministries, which act as supervisory bodies of the SPIC. The plan must include, among other items, the kinds of investments that the SPIC will use to raise the value of funds, as well as a projection of costs, including operational costs. Operational costs cannot exceed 6% of revenues within the first five years of operation of the SPIC and 3% after this period. Profits of the SPIC are to be allocated to the reserve fund (2.5%) or to the benefit of the insured persons.

The supervision of an individual SPIC has been the subject of criticism, since SPICs do not come under the supervision of the Bureau for Financial Markets, which has the capacity to control the investment activities of SPICs. On the other hand, the division of supervisory authority between the Ministry of Labour (responsible for supervision in the areas relating to fulfilment of defined contribution plans, the protection of interests of insured persons and pension beneficiaries), and the Ministry of Finance (which controls fulfilment of financial plans, observance of investment conditions, and the operation of the depository bank) can result in confusion and lack of co-ordination.

In May 2002, there were four SPICs operating in Slovakia. The Ministry of Finance is examining the application for a licence by another company. By the end of 2001, the four SPICs had 282 000 clients (10.4% of the economically active population) and managed funds accounting for SKK 3 billion (USD 65 million). Average contributions reached SKK 834, with 52% coming from

16. See www.employment.gov.sk.

employers. The average gross rate of return according to the Association of Supplementary Pension Companies reached 13%. Despite the relatively short existence (six years) of the system, the average pension from SPIC has reached 15% of the average wage.[17]

The spectrum of assets in which a SPIC can invest is quite broad:

- Bank deposits.
- Government bonds and treasury bills; bonds of the National Property Fund.
- Bonds traded on the stock exchange (up to 20% of funds).
- Shares of mutual funds (up to 20% of funds).
- Foreign securities traded either on the domestic or a foreign stock exchange (up to 15% of funds).
- Real estate (up to 10% of funds).

However, the current actual portfolio of existing SPICs is rather limited. This can be illustrated by the example of SPIC Pokoj (Table 3.1).

Table 3.1. Portfolio of SPIC Pokoj (as at March 2001)

Short-term deposits	23%
Medium-term deposits	56%
Government bonds in SKK	21%

Source: SPIC Pokoj.

In the future, the portfolio of assets should mainly consist of:

- SKK Eurobonds and other securities of subjects with an A rating, and higher.
- Eurobonds, T-Bonds, corporate bonds and securities in foreign currency, with ratings corresponding to the sovereign rating of the Slovak Republic and higher.
- Mortgage bonds.
- Short-term bank deposits.

When investing in bank products, the volume of investment in products of any bank cannot exceed 40% of its equity capital, or 25% of the value of the SPIC funds.

Recent amendments submitted to parliament in May 2002 will bring further changes to the system, mainly so as to be more in line with EU legislation. These changes are in the areas of recognition of pension insurance claims among insurance companies, the possibility of transferring pensions to other EU countries, and the obligatory participation of workers and their employers in selected higher risk work categories in the SPS.

The system of commercial life insurance and pension insurance has also been developing dynamically in Slovakia. In 2000, premiums paid for life insurance increased by 33%, reaching SKK 11 billion (USD 240 million). A specific and increasingly more popular product is investment life insurance, which combines insurance products with financial investments. These developments occurred despite the fact that insurance premiums for commercial purposes or for pension insurance are not tax-deductible, and benefits from this kind of product are taxed at a higher rate (15%).

17. See www.employment.gov.sk.

It is no surprise that commercial insurance companies are interested in participating in the projected third pillar of the pension reform and want to obtain conditions for their operation similar to those for supplementary pension insurance companies. So far, however, the government concept of the reform views insurance companies as part of a fourth pillar, based on voluntary participation and without any guarantees, incentives for clients or specific state supervision.

The government's concept of pension reform

The idea of transformation of the social security system came onto the agenda immediately after the socio-political changes at the beginning of 1990s. Despite some specific changes and adjustments to the existing system, a substantial change of the social security system (which was introduced in 1956) to a social insurance system, has not yet occurred.

The Concept of Social Insurance Reform (approved by the government of the Slovak Republic in August 2000) proposes the transition to a multi-pillar, diversified system with mixed financing. It also proposes the introduction of a new system relying on capitalisation of (part of) the resources raised, and other systemic changes. These include the formal calculation of old-age pensions based on the amount of contributions and the length of the contributory period, a gradual increase in the retirement age and uniformity in the retirement ages for both sexes, introduction of early retirement provisions where the amount of the pension is adjusted for early access, abolition of all cases of preferential treatment from the system, and abolition of all non-systemic benefits in the system.

According to the government's Concept of Social Insurance Reform, the future pension system will be based on three pillars:

1. A mandatory pillar based on pay-as-you-go funding. The idea is to progressively reduce the basic pension income from its current level to a level appropriate for social solidarity. The pillar will be administered by the Social Insurance Agency and be guaranteed by the government of the Slovak Republic.

2. A mandatory pillar based on individual capital accounts (currently non-existent). According to the concept, the pillar should be administered by the SIA and co-ordinated and financially guaranteed (up to the amount of the principal plus inflation) by the government. Although licensed investment companies will manage the assets within this pillar, individual accounts will be administered by the SIA.

3. A complementary (voluntary) pillar based on privately-managed pension funds. This system is currently represented by the supplementary pension schemes. However, commercial insurance companies are interested as well.

If the reform is launched in the form outlined in the concept, 25% of the total mandatory contribution will still be directed to the first pillar, with the remaining 3% targeted to the individual accounts. The ratio would then gradually change in favour of the individual accounts. The concept suggests a ratio of 19%: 9% in the year 2025. The combined resources in the first and second pillars in this situation should make up a pension corresponding to 50-60% of life-long average monthly earnings from which insurance contributions were paid – up to a maximum amount equal to three times the average monthly wage in the Slovak economy. The third, voluntary pillar should eventually guarantee pensions corresponding to 20-25% of life-long average monthly income.

With the intention of creating the conditions for implementation of a multi-pillar system, the Ministry of Labour drafted and submitted to the government the Act on Social Insurance, which deals

with both long-term (pensions), as well as short-term (sickness) benefits and accident insurance. In Spring 2002, the draft was being negotiated in the parliament. The Act, however, only modifies the conditions for the functioning of the PAYG pillar. The most important modifications include the introduction of a relationship (still relatively vague), between the period and amount of contributions and the amount of pension received, through a system of personal wage points, and the gradual increase in the retirement age of women to the unisex age of 60 years.

Further, the concept and the draft do not solve the problem of the ongoing preferential treatment of selected work categories, such as the police, military, secret service and customs officers. Furthermore, the shape of the second pillar is now only in the form of a draft concept being discussed within the government. It is highly improbable that reforms will be adopted within this term of government. There is, however, a positive sign, in that the government approved the use of half of the privatisation proceeds from the sale of a 49% stake in the gas company SPP, SKK 65 billion (USD 1.3 billion), for pension reform. The money is to be used to compensate for the decline in revenues in the PAYG system related to the introduction of mandatory contributions to the second pillar. If the reform is launched in a form corresponding to the concept, this money should be sufficient for the period until 2010. The government concept also counts on the utilisation of internal resources of the SIA (improved collection of contributions, sale of claims) and of external sources, including state bonds. However, since the final shape of the new system is not known yet, it is currently difficult to quantify the possible costs of the reform.

Among the most heavily criticised features of the Act on Social Insurance is the preservation of the contribution rate of 28%, the increase in the contribution calculation base to 3.25 times the average wage, as well as the missing reference to the second pillar. The main critics of the proposed Act on Social Insurance have been right-wing politicians. Their main argument is that the draft actually preserves the current status quo, with only minor modifications. It came, therefore, as no surprise when Deputy Peter Tatar, representing the small right-wing party OKS (Civic Conservative Party) submitted to the parliament another, more radical Act on Pension Insurance. Unlike the government draft, the OKS draft provides for a reduction in the overall pension insurance contribution rate from 28 to 19%, and places a greater emphasis on the mandatory private capital pillar based on individual accounts (10% compared to 9% proposed for the PAYG pillar). Consequently, the proposal of OKS also provides for a lower level of pension paid from the PAYG system (10-20% of wages). Both mandatory pillars should, according to this draft, ensure a pension corresponding to 30-60% of the wages achieved prior to retirement. It also provides for the existence of the third, voluntary pillar.

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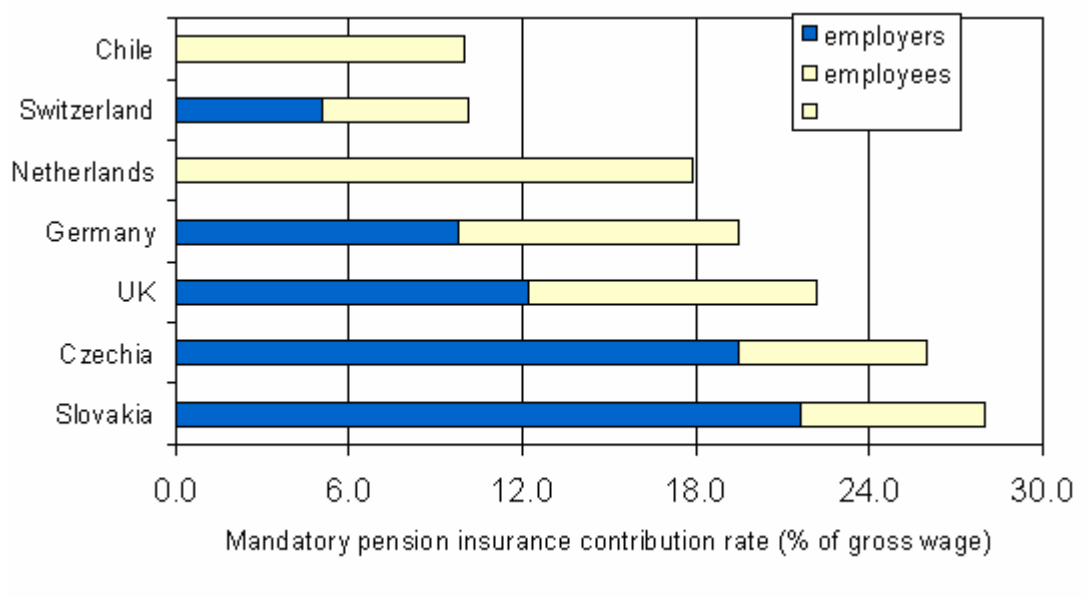
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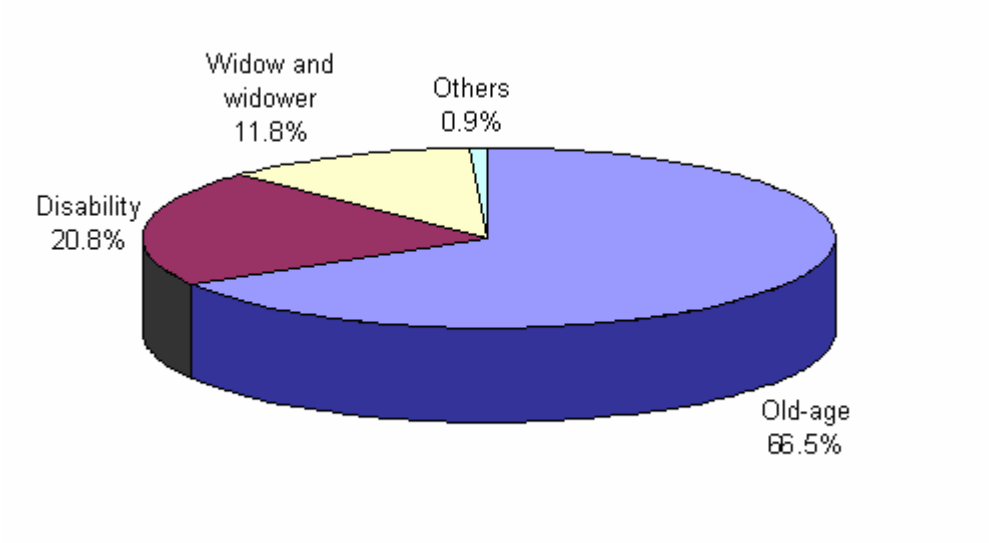
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Figure 3.1. Comparison of mandatory pension insurance contribution rates in selected countries



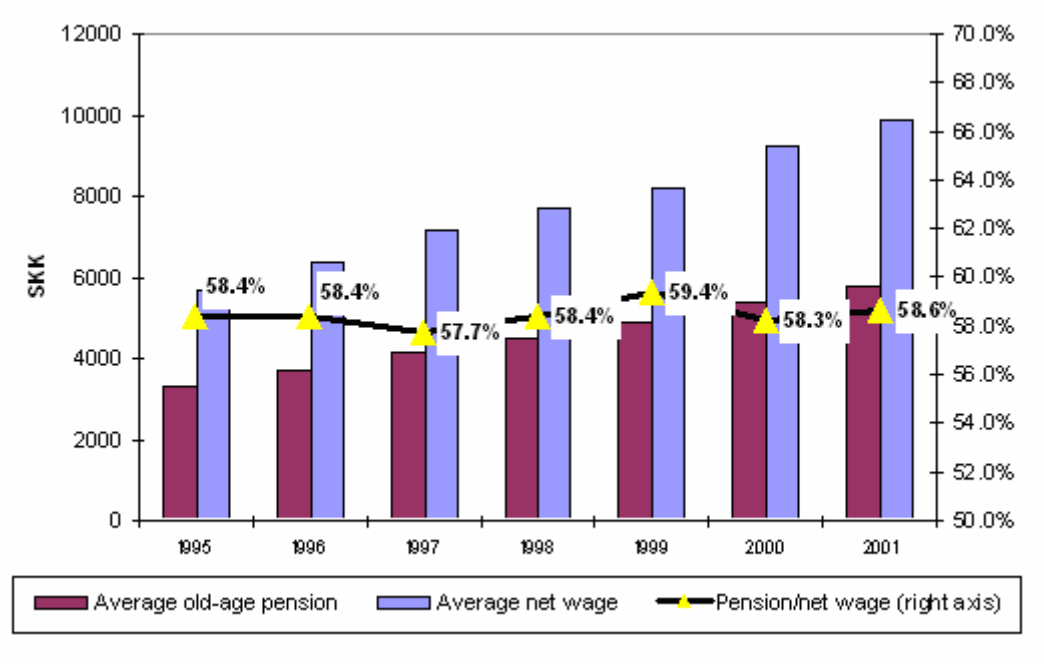
Source: MESA 10.

Figure 3.2. Structure of systemic pensions (2000)



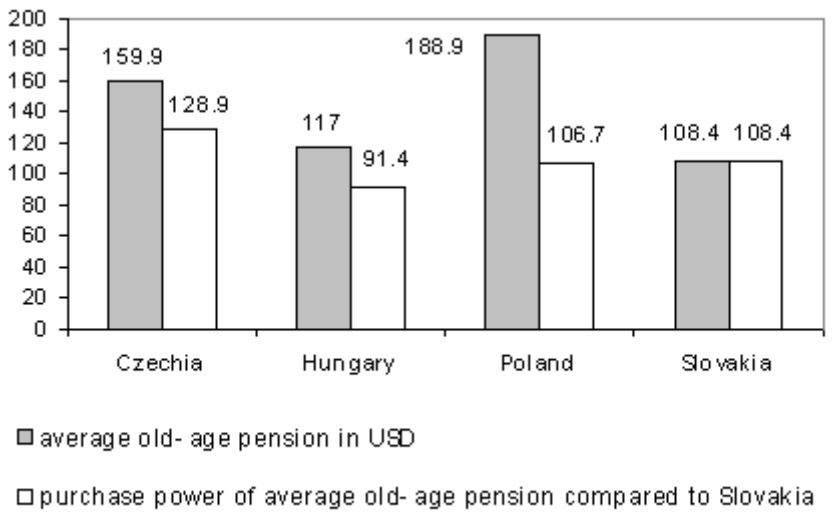
Source: Social Insurance Agency.

Figure 3.3. Old-age pension/average net wage ratio



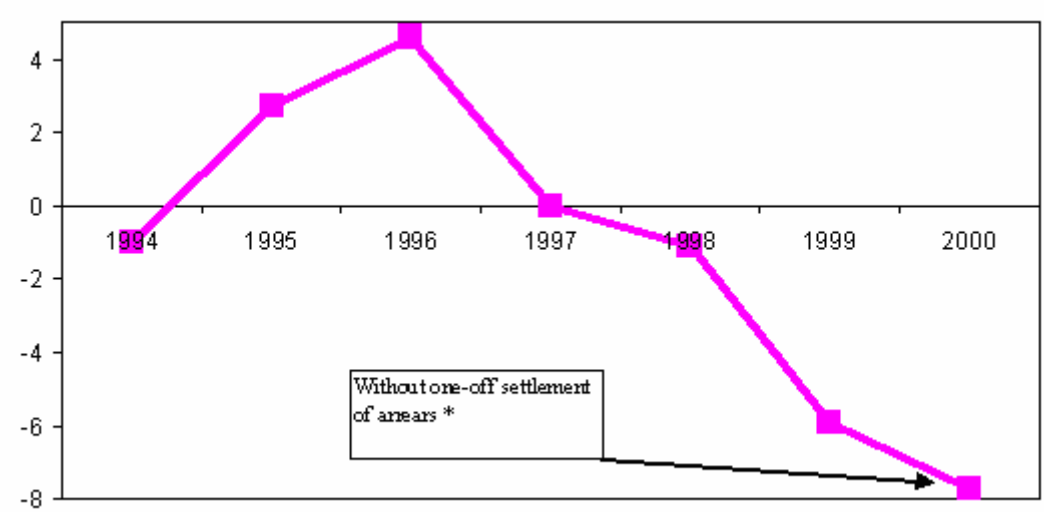
Source: Statistical Office, Social Insurance Agency. MESA 10.

Figure 3.4. Comparison of average old age pensions in Slovakia and V4 countries (USD, 2000)



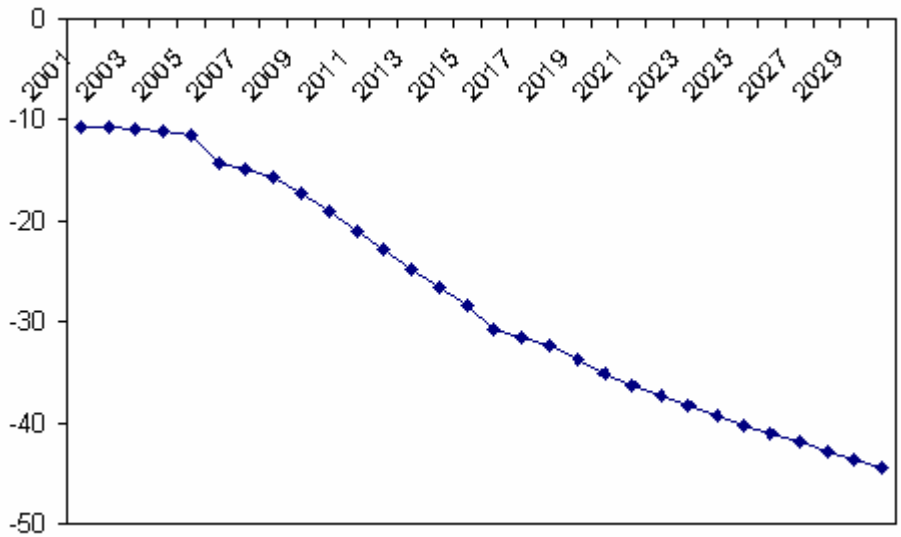
Source: CESTAT, OECD; Calculation: MESA 10.

Figure 3.5. Performance of the pension fund of the Social Insurance Agency



* See footnote 5.
Source: Ministry of Labour, Ministry of Finance, MESA 10.

Figure 3.6. Projected deficit of the Social Insurance Agency under current system



Source: Ministry of Labour.

Chapter 4

PENSION REFORM IN GERMANY: AN ASSESSMENT

by
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Introduction

The pension reform, enacted in 2001, is considered a major structural change in the German pension system.[1] The core element of the reform is a (partial) shift, from pay-as-you-go (PAYG) funded social security pensions, to pre-funded, occupational, and private, pension plans. Whether these changes were big enough to call the reform systemic, or parametric, remains to be seen.[2] In order to assess the scope of the reform, a brief description of the German pension system is given below.

The German pension system

The German system of pension provision should be described as a multi-pillar system. The first pillar is highly stratified, and provides pension insurance, according to occupation. It comprises the statutory pension insurance for workers, miners, and employees, the pension schemes for civil servants, and for farmers and, finally, professional pension schemes for the liberal professions, such as lawyers, medical doctors, architects, etc.

On top of, and complementary to, the statutory schemes of the first pillar, voluntary employer-sponsored occupational pension schemes, and voluntary individual investments into homes, life assurance, and all kinds of saving schemes, form the second and third pillars, respectively. Occupational schemes cover about 50% of the labour force. Until the present time, about 70 to 80% of the pensions, paid from all schemes, are funded through the PAYG method, and 20 to 30% are fully funded.

The focus of the pension reform of 2001, was on the statutory pension insurance for workers, miners and employees, and related adjustments in occupational, and private, schemes.[3] Therefore, this paper will be restricted to these core elements.

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1. See, for example, European Commission (2002), pp. 26-30; Cerulli Associates (2001), pp. 5-7.

2. See Chand and Jaeger (2002).

3. To ensure equal treatment in all state schemes, the benefit levels in the pension schemes for civil servants and for farmers were lowered in a similar way. But the statutory pension insurance scheme reform took the lead.

Characteristics of the statutory pension scheme

The statutory pension insurance scheme is based on principles of social insurance. The insurance principle implies that pensions are linked to life-time earnings. The solidarity principle precludes the application of risk-related contribution rates, or the like, and requests unisex tariffs. Pensions are indexed to wages. Expenses are funded from contributions levied on gross wages, and equally shared between employees and employers, and topped-up by transfers from the federal budget, to meet the expenses for the redistributive part of the scheme, resulting from assimilated periods granted, *e.g.* for child rearing, military service, unemployment, etc. For the long-term insured, the statutory social insurance pension scheme used to provide income replacement, at a level that allowed the insured persons to maintain the living standard acquired, in the course of their working lives.

Reasons for pension reform

Pre-reform developments

In the course of the 1990s, the German pension system underwent a number of changes, in order to meet the challenges of German reunification, and to strengthen its long-term sustainability. The changes should limit short-term increases in the contribution rate. Measures taken, included remarkable cuts in pension entitlements. Despite these measures, the contribution rate required to balance the pension scheme's budget rose from 18.7%, in 1990, to 20.3%, in 1997. Further increases could be avoided only through increases in the tax-financed transfer, from the federal budget. The failure to stabilise the rate of contribution in the short run, and forecasts[4] of long-term developments of contribution rates above 30%, weakened the political consensus on the affordability of the current PAYG pension scheme.

In 1998, a new government came into office, and decided to curb the increase in the contribution rates, and to increase the transfers from the budget. The extra transfers were financed from additional taxes, levied on the consumption of gasoline. These measures should restore short-term financial stability to the pension scheme, while lower contribution rates should help the labour market to create more employment opportunities. This action enabled contribution rates to decline, to 19.3% in 2000, and increased the budget transfers, to about 30% of the pension scheme's expenditure. The government hoped that, in conjunction with an upswing in the business cycle, these measures would lead to higher employment, and thus reduce the need for drastic changes in the pension law.

Long-term challenges

After short-term stability was restored, the government started to take action on long-term problems. Their concerns were about the issues outlined below:

1. Fertility rates in Germany have been declining, for three decades, as in most industrialised countries. Higher life expectancy has increased the duration of pension payments. The resulting demographic ageing of the population had already required a rise in the rates of pension contributions. If the current income levels of the elderly were to be maintained, contribution rates had to rise from about 19.5% to 24%, to 26% by 2030. This burden would be unacceptable for the younger generation to bear, above all, because it would become more and more difficult for the German economy to compete successfully, in an increasingly globally integrated economy.

4. FERI (1997).

2. The strategy to lower the financial stress, in social security schemes, by a more prosperous labour market – as described above – had only limited success. In 2000, unemployment was still high, and underlined the need to downsize the benefits, paid from the statutory scheme.

3. The rates of return of investments, in the capital markets, were very high, during the nineties. This made fully-funded pension schemes more cost effective, and attractive.

4. In addition, the statutory pension system seemed not to be fully adjusted to changes in lifestyle, such as less stable family relations, or to an increasing preference for individual solutions, nor to changes in the labour market, for example, rising female participation, and more flexible work arrangements.

5. Finally, there was a need to enable the elderly to access poverty alleviation programmes, through the pension administration system, and to separate such access from general social assistance. The reason for this is that poverty alleviation measures often fail, as the elderly feel ashamed to contact the social assistance administration directly, at the municipal level. Enabling contact to occur through the more respected pension administration system is to be preferred. An elderly person might also, thus, be able to avoid having the social assistance administration ask for the reimbursement of any expenditure on poverty alleviation, from those of their children who may be able to afford to pay.

Objectives

The pension reform of 2001,[5] in Germany, followed a multi-faceted approach, which aimed to respond to the challenges mentioned above and, as a result, to adjust the German pension system, positively. The principle objectives may be summarised as follows:

- Stabilisation of the contribution rates, for the near future, and limiting the increase in contribution rates, caused by the demographic transition, to a rate of 20%, by 2020, and 22%, by 2030.

- The reduction of benefits should be designed in such in a way that the replacement rate for a standard pensioner would not fall below 64%.[6]

- Creating arrangements for more private pension provision.

- Adjustment of the pension scheme to changes, in society, and the labour market.

The government was convinced that meeting these objectives would remove major pension issues from the political agenda, for many years. It would secure the long-term sustainability of the pension system, and establish a fair burden sharing between generations, during the period of demographic transition, to an ageing society.

5. See Deutscher Bundestag (2000).

6. A standard pensioner is defined as one who has an insurance record of 45 years and was an average income earner during his working life. The head-line replacement rate is maintained at 67%.

Core elements of the reform

Summary of measures

The pension reform comprised the following measures:

- Reductions in the net replacement rate, from 70% to 64%. Maintaining a head-line replacement rate of at least 67%, until 2030.

- Change in the indexation rule. Before the reform, pensions were increased, at the same rate as net wages. The new indexation rule provides for a modified concept of net wages, which will lower the replacement rate.

- Establishment of supplementary pension provision.

- Additional pension credits for child rearing, and reform of survivors' pensions.

- New social assistance schemes for the elderly, and invalids.

Basic approach to reform

Due to the recent pension legislation, the replacement rate, under the current PAYG social insurance pension scheme, will gradually decline, from 70% to 64%, until 2010. To make up for the long-term shortfall of provision, new schemes of voluntary supplementary pension provision have been established. These will change the role of private pensions, since, in the long run, they will become a necessary component of retirement income, if the living standards of the elderly are to be maintained, during retirement.

Of course, the conventional, and traditional, ways of private pension provision, will be still available. Participation in new private schemes will be voluntary. However, the state will be involved through regulation, licensing, and provision of tax relief, and allowances. In addition, employers may become increasingly involved, as collective agreements with trade unions are concluded, stipulating additional particular employer sponsorship of company, or industry-wide, pension funds.

The new private schemes

The new supplementary pension provision schemes are to be implemented from 2002 onwards, either through occupational pension provision, or private pension plans. Both instruments are eligible for significant financial support, through government allowances, and tax relief. At present, it is too early to judge which type of scheme will attract more clients, or assets.

Pension provision contracts

Individual access to the new scheme is conditioned on concluding a pension provision contract (PPC). A PPC is a form of individual (pension saving) account, that can take the form of:

- Private pension plans.
- Insurance capitalisation products.
- Investment fund certificates, or
- Bank saving plans.

A PPC has to meet a number of requirements and conditions, to be eligible for the tax subsidies mentioned above. These conditions comprise, in particular, the following items:

- The plan should accumulate funds to cover the risk of old-age income maintenance, and optionally, invalidity and survivors' pensions. Old-age pension delivery must not start earlier than the age of 60.

- The accumulated pension capital must be paid out in the form of a monthly benefit; no lump-sum payments can be made. Benefits may only be delivered in the form of a monthly pension, or a monthly fixed or variable annuity, with a life pension starting at age 85 to cover the longevity risk.

- The contract could include an option on a temporary withdrawal of capital from the account, for the sole purpose of acquiring home or flat ownership.

- Companies offering PPCs are obliged to inform the client, before the conclusion of the contract, about the fees for concluding or dissolving the contract, managing the assets, and the marketing cost. They must disclose information on volume, and structure, of the investment portfolio, and of the individual's account.

- Companies must pledge that, at least, the nominal value of the contributions will be available, when the contract is due to be annuitised (zero nominal minimum rate of return). The contract must include the right to switch to an alternative PPC, with the same, or a different, company.

- Insurance companies, investment funds, banks, or financial intermediaries, may offer PPCs.

Relevant German regulations on insurance, banks, funds and securities, apply to PPCs, as well. Additional regulation was enacted, to stipulate that PPCs ought to be certified by the Bundesaufsichtsamt fuer das Versicherungswesen (Federal Supervisory Office of Insurance Companies). The certification only guarantees compliance with the stipulations of the tax code.

The administrative procedures for paying the allowances are handled by the Bundesversicherungsanstalt fuer Angestellte (BfA − the Federal Insurance Institute for Salaried Employees).

Occupational pension provision

Introduction

In Germany, occupational pensions can be provided in five ways. These comprise direct promises, covered by book reserves, support funds (with and without reinsurance), direct insurance, pension trust funds (Pensionskassen), and pension funds. Of these, the last three forms mentioned are eligible for receiving state support, under the new rules. The recent pension reform has improved the conditions for occupational pensions, as vesting periods were reduced, and portability was made easier.

The right to an occupational pension

In Germany, employers voluntarily provided occupational pension provision. The pension reform entitled every employee to request occupational pension provision, from his or her employer. The decision, on how to implement these schemes, remains with the employer. The minimum provision is a salary for pension arrangement, backed by an assurance contract.

Pension funds

The introduction of pension funds, as an additional instrument for occupational pension saving, was seen as a significant step, in increasing the attractiveness of occupational pension schemes.[7]

Basically, German (new model) pension funds are insurance companies, under the supervision of the insurance supervisory institution. This arrangement has been criticised, as pension funds tend to be more like investment funds, and should therefore be regulated, under investment fund law (Kapitalanlagengesetz). In relation to many of the details of pension fund regulation, the law itself was rather incomplete. However, these issues were subsequently resolved, through government orders. In particular, the investment rules have been defined. While traditional insurance companies, and pension trust funds (Pensionskassen), are not allowed to invest more than 30% of their portfolio in equities, there is no cap on equity investing for pension funds. A higher proportion of equities could mean higher returns, and lower costs. Regulation should follow the so-called prudent person rule.

Collective agreements

The social partners plan to extend the coverage of occupational pensions, with a long-term preference for pension funds. Negotiations, between the social partners, to set up pension funds, have started in a number of industries. Of those industries that were among the first to engage in such negotiations, the construction industry, the metal processing and electrical industry, and the chemical industry, have concluded agreements. Table 4.1 summarises some of these schemes. However, the implementation of these schemes is at a very early stage.

Tax treatment and state subsidies

In order to promote its growth, saving in PPCs is significantly subsidised, through allowances and tax breaks. The tax treatment of PPCs follows the well-known EET model. Contributions made to PPCs are deductible from the income tax base, up to a limit, starting at 1% in 2002, and gradually increasing by 2008, to up to 4% of the previous year's income, which is liable for social security contributions. Interest earnings, during the phase of accumulation, are tax-free. Benefits from PPCs are fully subject to income tax. Payment of capital, as a lump sum, leads to an obligation to pay back the tax advantages, and allowances received.

As tax breaks have a regressive distributive impact in a progressive tax regime, favouring high-income earners, allowances are also granted, in an inverse relationship to income, and are dependent on the number of children an individual has. Tax authorities check whether allowances, or tax breaks, are more favourable. To receive state support in full, minimum contributions must be made, dependent on income, and on the number of children. A survey of the conditions is given in Table 4.2.

State subsidies support the formation of pension capital. The volume of support will come to DEM 20 billion in 2008. Additional tax breaks are provided, for employer sponsorship of occupational

7. See Sasdrich (2002) and BMA (2002).

pensions. For example, from 2002, employers can deduct contributions to pension funds, of up to 4% of an individual worker's income.

Why were particular approaches taken?

The approach taken by the German pension reform was influenced by a number of features particular to Germany.

The role of history and tradition limits the scope for privatisation. Apart from the usual problems of transition from PAYG to fully funded schemes, the major obstacle to more private pension provision came from the success of the statutory pension scheme in Germany. Pension provision, based on social insurance principles, has worked quite well, over more than 100 years, and has survived two wars. Recently, it was able to absorb the burden of pension provision to pensioners from East Germany. As the benefits became more generous in the course of time, the risk of old-age poverty was greatly reduced during the 1970s, and was much lower than in many other countries.

It was clear that the system, as such, had to be maintained. During the election campaign of 1998, the reputation of the traditional system grew, as the winning coalition called the previous government's reform proposal unnecessary, and damaging to the vulnerable. It was quite clear that, after such an election campaign, a radical reform would be difficult to table.

Model savings plan. In Germany, employees are entitled to sign up for subsidised saving plans. These plans are widely used, in particular, to save for a house or a flat. Withdrawals from the savings plans are earmarked, for housing purposes, or available only if subsidies are paid back. Saving for private pension provision should follow a similar approach. The design of the supplementary pension contract did indeed follow the model of subsidised savings plans, which explains the detailed conditions of these contracts.

The role of trade unions. Opposition, to the privatisation of pension provision was bolstered by trade unions. They were represented on the management boards of the statutory pension scheme. They favoured the equal sharing of financial costs, between employees and employers. Privatisation of the scheme would reduce the cost for employers, and increase the cost for employees. As the trade unions requested compensation for that, the framework for occupational pension provision was enlarged, tax rules for occupational schemes became more favourable, and trade unions obtained the right to veto particular salary for pension agreements. Finally, a political guarantee, to maintain the new replacement rate of 67%, was included in the law.

The role of the financial industry. As soon as the plans for private pension provision were revealed, the financial industry welcomed the idea in principle, and began to fight for as little regulation, and as few conditions, as possible.

Achievements so far, and implementation

Consumer information

Immediately after the law was passed, in May 2001, finance companies started to advertise the new supplementary pension plans. This was, at least partially, misleading, as the supplementary pension plans needed certification, before coming into operation, and this was not to be done until December 2001. Sales became legally possible, after 1 January 2002. There were particular rules to modify, and incorporate, existing contracts, into the new type of contracts. However, modification was difficult to achieve, and where it was possible, the terms were not advantageous for the consumer.

In addition, the still high head-line replacement rate, and the concealment of the effective cuts in the replacement rate, have not, so far, created the level of public awareness needed to push the demand for additional pension saving. There is also a general feeling of uncertainty about, and distrust of, finance companies.

In order to increase public awareness, and help to develop financial literacy in the general public, the pension administration has used the entitlements, created by the new law, to expand its advice services, to general information about occupational, and private, pension provision. Despite these efforts, the public does not feel well informed about the pension reform, as is shown by a survey conducted by the Deutsche Institut fuer Altersforschung (DIA, 2002). Seventy-one per cent of the population do not plan to sign up to a pension scheme, under the new provisions (the Reister pension).

Financial products

To date, about 4 000 products have been licensed. Life assurance companies, banks, and credit institutions, and investment funds, are able to offer licensed products to the consumer.[8] However there is only anecdotal information about how many of these products are actually sold. Many financial institutions prefer to sell other investment vehicles, because they want to avoid the administrative tasks related to the payment of allowances. Those who want to sell the products, complain of low demand. Until recently, only 1.6 million, of a potential 20 million, contracts were signed. The question arises, as to why consumers are so reluctant to sign up for a "Riester-product"?

The reason could be that the true costs of "Riester-products" are very opaque.[9] Suppliers largely understand how to evade the rules, about disclosure of fees. Charges are levied in such a way, that only experienced analysts are able to figure out the true cost structure. Up to now, the guide books available provide only general information,[10] which is useful as a starting point, but does not provide adequate information, to enable a consumer to make a decision to enter a scheme. Moreover, only guides to individual schemes are available for the consumer. Comparative analysis is, more or less, lacking, but some will be published, in the summer of 2002.[11]

Occupational pension schemes

The social partners have concluded more than 100 collective agreements, on occupational pensions. Not all of them use the new legislation. Three major, new, occupational pension schemes were founded for the chemical, the construction, and the metal processing and electrical engineering industries.[12] Up to now, only a few pension funds have been licensed, due to of a shortage of manpower in the supervisory office.

It is difficult to assess if that really matters. Most employees, who want to join the new salary for pension schemes, will use the Christmas bonus for the payment of the contributions. By then, these institutions will be in place.

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8. See Engels (2002).

9. See Rische (2002).

10. See Tiffe and Reifner (2002), Stiftung Warentest (2002) and Stiftung Warentest (Hrsg./Ed.) (2002).

11. See Morgen and Morgen (2001). This analysis was published in October 2001 before the first "Riester-products" were certified in December 2001, so it was rather preliminary.

12. The schemes are described in detail in Sailer (2001*abc*).

Impact on the financial market

The new scheme is expected to give a significant boost to the German financial market. Experts estimate that between 75% to 80% of the 27 million people entitled to participate in the scheme, will do so. This could create an annual inflow of EUR 30 to 50 billion after 2008. After ten years, EUR 200 billion would accumulate.

Following the experience of other countries, the current regulations will be amended, and changed, in the course of time, as risks, and opportunities, are seen more clearly.

Impact on living standards and income during retirement

Since the recent pension reform will reduce the replacement rate significantly, those who make additional investments in private pension provision will, in future, only enjoy the income levels of the present generations of retirees. The supplementary pension scheme was specially designed, so that savings could make up for the gap created by the reform, or even overcompensate it. The baseline model, of the supplementary pension scheme, was developed under modest economic assumptions. In consequence, for those who join it, the retirement income situation should not be different, from those with pre-reform incomes.

However, there are some groups, for whom the standard scenario might not apply. First of all, those who retire during the next decade will experience a sharp decline in replacement rates, but they do not have enough time left to save the necessary pension capital, to compensate for that decline. Some products – assurance contracts – are not even accessible to those over the age of 55. Problems may also occur for those starting their work careers after 2020, as they will have to bear the peak contribution rates, and at the same time, must fund their private plans, when they are at their most productive.

Groups of low-income earners may also cause concern, in particular, those with short employment records. For them, saving in a private scheme may still not prevent their retirement income being close to social assistance level.[13]

In addition to the planned curb on pension entitlements from the pension reform, an unplanned curb of the money value of pension rights may emerge from an extensive use of salary for pension arrangements. These arrangements transform gross wages into employer contributions to social security. As a consequence, gross wages (or growth of gross wages) will be lower. As the money value of pensions is linked to the growth in wages, a relative decline of pension growth will result. That would not be the case, where employees decide to save in private pension plans.[14]

Besides those general issues, there are a number of risks ahead that could endanger the income level of future retirees.

Reduced coverage of population

The reform shifts compulsory pension insurance to voluntary supplementary pension plans. That may reduce coverage, if particular groups of the population do not join any of the new schemes. As

13. See Schmaehl (2001).

14. For details see Sailer (2002).

long as only high-income earners do not, this may not cause a social policy problem, or create a future burden for social assistance.

Low-income earners should not have a reason not to join the supplementary schemes, since the system of allowances is fairly generous, as shown in Table 4.2. However, while tax breaks are indexed (4% of income threshold), allowances are not. This will not cause a problem until 2008, when they will be fully implemented, but may eventually become a barrier to entry, for low-income earners.

Reduced coverage of risks

The statutory pension insurance scheme covers the risk of invalidity, longevity, and of leaving survivors. Under the voluntary scheme, insurance of invalidity, and surviving spouses, is optional. Although more choice as to coverage may be desirable, individuals may not correctly anticipate the risk of invalidity. In addition, it cannot be certain that financial markets are able to correctly anticipate the longevity risk.

Inter-generational and distribution issues

The burden of transition to more advance funding of pensions, will not be spread evenly across cohorts and income brackets. A number of studies, using generational accounting methodology, have been carried out, to assess the impact of the reform. Research by Fehr and Jess (2001) has shown that, in comparison to the pre-reform rules, the reform will favour the younger generation and, surprisingly, medium and high-income earners. These effects emerge from the generous deferred taxation rules.

Financial market risk

Finally, private pension provision includes the risk of the financial markets. A "guarantee" of the principal provides at least protection against total loss of the pension capital. However, in most cases, the sum of contributions would not provide sufficient pension income.

Sustainability

As the implementation of the recent pension reform occurred only a short time ago, and as the impact of previous reforms – *e.g.* the termination of subsidised early retirement schemes, and the increase in the retirement age – only shows itself gradually, the sustainability of the reform is difficult to assess. The future debate on sustainability will have to answer two questions:

1. Are the contribution rates of 20% and 22%, respectively, which are envisaged for the coming decades, economically sustainable, and sufficient to fund the target replacement rate of 63%? Or is a further extension of privatisation required?

2. Will the supplementary pension schemes keep their voluntary character?[15]

As to the first question, it must be stressed that there is currently no significant debate in Germany about cutting the benefit level further, or increasing the private schemes, after 2008. Nevertheless, there is no general consensus that a contribution rate of 22% will be affordable, after 2020. Employers' organisations seek to limit the rate of contribution, strictly, to 20%.

15. The advantages and problems of voluntary pension schemes are discussed in World Bank (1994).

Simulation analyses[16] have shown that the combination of the contribution rates envisaged, and the target replacement rate, is feasible only under economic conditions, where there is significantly more employment. A more substantial decline in the mortality rate would require much higher contribution rates of about 25%. However, these are developments that will happen only after 2020. Until then, it is very likely that an upper target contribution rate of 20% is sufficient.

As to the second question, the social law has already provided for a review process. An assessment of the new private schemes' success, in terms of coverage, is due by 2005. A failure of the schemes regarding vulnerable groups of the population, will certainly lead to a request for additional measures, including obligatory schemes.

Implications for other countries

In every country, pension systems rely on quite a number of institutions. The institutional frameworks of the labour market, of the financial markets, and of the legal system, the rules of decision-making and legislation, play their particular roles. Pension systems evolve, and develop over time, and therefore form their own traditions.

Thus, it is rather difficult to propose meaningful generalisations for the reform processes, in other countries. Tentatively, the lessons to be learned from the German experience, so fa,r could be summarised as follows:

- The impact of the short-term financial stability of the statutory pension scheme on the reform process was ambiguous. On the one hand, it allowed the reform to focus on long-term issues; on the other hand, it lowered the pressure for reform, and increased general opposition.

- The introduction of new systems or systemic elements require more public awareness, than has been achieved in Germany, so far. Financial companies must enhance their reputation with consumers. If privatisation of pension provision is combined with product choice, the enhancement of financial literacy, and consumer protection, is necessary, to encourage participation in the new scheme.

- Opposition to the reform was lowered as traditional players – trade unions – obtained a role in the new scheme.

- A comprehensive agenda of pension system reform would have included a revision, and harmonisation of tax rules, for pensions. That, however, was not feasible.

16. See Bonin (2001).

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Table 4.1. Selected examples of occupational pension schemes using new legislation

Industry	Employees *(000s)*	Organisation	Funding	Employer sponsoring
Metal processing and electrical industry	3 500	External organisation as pension trust fund, pension fund or direct assurance Priority for company pension plans Establishment of industry-wide occupational pension provision scheme	Voluntary salary for pension arrangement of up to 4% of income threshold in statutory pension scheme	Organising and administration
Construction industry (West Germany)	950	Priority for company arrangements Industry-wide pension trust fund managed by Bau-Sozialkasse	Voluntary salary for pension arrangements without upper limits	DEM 60 per month for a monthly minimum saving of DEM 18. No accumulation with state sponsored wealth formation plans
Chemical industry	590	Priority for company arrangements Industry-wide pension trust fund and direct insurance	Voluntary salary for pension arrangements from bonuses of up to DEM 4 176 Company arrangements allowed	For the base amount of saving DM 936 p.a. as before DM 264 are granted. For additional EUR 100 saved EUR 13 are granted
Gross and international sales	1 200	Company agreements Industry-wide pension trust fund as complementary scheme	Salary for pension arrangements from bonuses up to 4% of gross salaries	DEM 312 from state sponsored wealth formation plans plus 15% from salaries for pension arrangement
Retail sales	2 300	Company and industry-wide plans	DEM 587 per year and employee (pro-rata arrangement)	DM 312 from state sponsored wealth formation plans plus DM 275
Food industries	55	Industry-wide pension trust fund	Salary for pension arrangement for at least 0.35% of gross salary	0.35% of gross salary

Source: Leaflets produced by IG Metall, Gesamtmetall, IG Bau, IG Chemie, Ver. di, NGG; compilation by author.

Table 4.2. State support to supplementary private pension provision

Period	Basic allowance	Allowance per child	Maximum tax break per year	Minimum contribution	Basic contribution		
					Without child	With one child	Two or more children
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	EURO	EURO	EURO	%*	EURO	EURO	EURO
2002-2003	38	46	525	1	45	38	30
2004	76	92	1 040	21 040	90	38	30
2005	76	92	1 050	2	90	75	60
2006-2007	114	138	1 575	3	90	75	60
From 2008	154	185	2 100	4	90	75	60

* Per cent of income liable for social security contributions, minus basic and children's allowances.

Source: Bundesministerium der Finanzen.

Chapter 5

THE ROLE OF THE EUROPEAN UNION IN PENSIONS

by
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Public pension expenditure in the European Union, 2000-2050

The concern about rising pension expenditure has for some time been high on the agenda of the Ministers of Finance of the European Union (EU) Member States. They have looked into it in their ECOFIN Council meetings on the basis of various reports, the most recent comprehensive expenditure projection being a report entitled "*Budgetary Challenges Posed by Ageing Populations*" (October 2001).

This report was produced by the Economic Policy Committee (EPC), comprising officials from the Ministries of Finance, Central Banks, and the European Commission Directorate-General responsible for Economic and Financial Affairs. It covers the impact of public spending on pensions, health, and long-term care for the elderly. Given the fact that this report is drafted for the Ministers of Finance, it approaches the ageing problem primarily from the point of view of the long-term sustainability of public finances.

The expenditure projections for each Member State are made by each national administration under jointly agreed assumptions on key demographic and economic variables. The population projections were made by *Eurostat*, the Statistical Office of the EU. Key economic assumptions on the growth of productivity, employment and unemployment, inflation, etc. were agreed upon within the Committee in order to establish a common basis and allow for comparability of the results. This work was done in parallel with the work at the OECD, which covers also non-EU OECD member countries, *i.e.* also the Czech Republic, Hungary and Poland.

According to the EU report, pension expenditure in EU-15 now amounts to 10.4% of GDP, and will peak in 2040 at 13.6% of GDP (see Table 5.1). There are fairly significant differences in both the level of expenditure in 2000 and in the future increase. Currently, in the UK and Ireland, expenditure is approximately 5% of GDP only. In the UK, it will decrease in the future. At the other end of the spectrum is Greece, where expenditure will double from 12.6% to 25% by 2050.

1. Views expressed are exclusively those of the author and should not be attributed to the European Commission.

The projected pension expenditure trend can be broken down into the following key factors: 1) the ratio of the population aged 55 or over to the working-age population; 2) the ratio of employed to the working age population; 3) the number of pensions in relation to the population aged 55 or over; and 4) the average pension as a percentage of GDP per person employed. The most dominant of these factors, putting upward pressure on expenditure is that of ageing, *i.e.* the proportion of elderly. According to projections, the average level of pensions decreases, alleviating a little over one-third of this pressure.

In terms of expenditure on health and long-term care, the EU-15 average level is currently 6.5% of GDP. Health care accounts for over 5 percentage points of this figure, while long-term care represents 1.2% of GDP. The total amount is projected to increase to 9% by 2050, with a relatively more rapid increase in long-term care, a factor that will exert significant pressure in the long term. There are fairly significant differences among Member States; in particular, increases are higher in instances where the level is already high.

The study demonstrates convincingly that nearly all EU Member States are facing serious problems for their public finances as a result of ageing populations. Solving the problem will require further reform of their pension systems, as no single measure will suffice. Increasing the effective retirement age, reducing benefit levels, and building financial reserves are all necessary to alleviate the pressure of projected expenditure 30 to 50 years from now.

Role of the EU versus authority exercised by Member States over pensions

It is most important to remember that Member States exercise authority over their social security systems, while the European Union has no overall authority in this field. Despite this, a lot of work is being done in this sphere within EU institutions. To understand why and how, a few institutional aspects related to the working of the European Union need to be clarified.

There are three categories of EU activities in the field of pensions: 1) directly binding EU legislation, 2) indirectly binding EU legislation, and 3) non-binding co-operation.

1) Directly binding EU legislation (including proposals)

The directly binding EU legislation, broadly speaking, covers the following fields (without this being an exhaustive list):

- Free movement of people [Treaty establishing the European Community (TEC), Article 42 pertaining to the portability of pension rights]: this guarantees that people do not lose the rights acquired under the public pension system if they move from one Member State to another.

- Freedom of establishment (TEC Articles 43 and 49): this guarantees that, in the field of private pensions, companies and people from other Member States have the same rights as nationals to establish businesses.

- Provisions on capital movements (TEC Articles 56 to 60): this states that if autonomous pension funds exist, their investments abroad will not be restricted.

In addition, a proposal that seeks to establish common standards on prudential regulations and supervision for occupational pension plans is now at the final stage of being adopted.

A document has also been prepared by the Commission regarding the elimination of tax obstacles to the cross-border provision of occupational pensions. In this paper, a comprehensive strategy is presented to address the tax obstacles discouraging cross-border pension provision. This is always a difficult area because of the requirement of unanimity in the Council.

2) Indirectly binding EU legislation

EU legislation in the field of public finances, in general, has implications for pension financing. Sound public finances is an obligation (TEC Article 4), implemented in the EU through the co-ordination of economic policies under Broad Economic Policy Guidelines, which include recommendations (TEC Article 99), and under the Stability and Growth Pact, which incorporates medium-term programmes for each Member State. The provisions also contain the excessive deficit procedure, which could even lead to the imposition of sanctions on a euro area Member State that exceeds the limits imposed on government deficits and fails to follow the recommendations to remedy the situation.

This legislation is binding in the following sense: inasmuch as public pension systems generally represent an important part of public finances, a serious imbalance in them will be dealt with at the EU level, and the Member State is required to remedy the situation. However, in the context of pensions, this legislation should be labelled as *indirectly* binding, because these EU provisions only apply to pensions through a more general assessment of public finances. This is so because these provisions do not specifically mention pension systems, so the matter is addressed only if a pension system causes a more general public finance problem. The corrective actions taken should be set forth in both the economic policy programme of the Member State in question and in the recommendations of the ECOFIN Council (to be proposed by the Commission).

The risk that a financially unsustainable pension system could cause a problem for public finances has since 1997 drawn a lot of attention within the Economic Policy Committee (EPC), which assists the ECOFIN Council. It was agreed in 2001 that Member States should present, at regular intervals in their Stability or Convergence Programmes, long-term projections for their pension expenditure. This is a way to ensure that due attention is given to the long-term consolidation of public finances in the Stability and Convergence Programmes, which are otherwise mostly geared towards medium-term issues. The first assessment of the results was presented in the report "Public Finances in EMU – 2002". The results of the work on ageing populations are also annually integrated into the *Broad Economic Policy Guidelines*, which contain recommendations for Member States.

3) Non-binding co-operation

New initiatives for raising the profile of the EU in the social policy sphere were gradually mounting in the 1990s, and led in July 1999 to a European Commission Communication entitled "*A Concerted Strategy for Modernising Social Protection*". These initiatives emanated from the Directorate-General of the Commission responsible for Employment and Social Affairs and from the social affairs ministries in Member States. They sought to protect the European social model from the pressure of market forces and the requirements of Economic and Monetary Union, notably the EMU restrictions on public finances. While these are complex issues that can be approached from a wide variety of angles, it should always be noted that in order to safeguard social protection systems, they must be placed on a financially sound footing. This holds regardless of EMU provisions.

The concerns about the European social model led first to the establishment of a High Level Working Party on Social Protection composed of senior officials of the Member States and the Commission. It reported to the Lisbon European Council (Summit) in March 2000, which assigned the

following mandate to the working group "to prepare … a study on the future evolution of social protection from a long-term point of view, giving particular attention to the sustainability of pension systems".

The work has continued within the Social Protection Committee (SPC), which was established following an addendum to the Treaty (new Article 144), negotiated in Nice in December 2000. At the Gothenburg European Council in June 2001, the Member States unanimously committed themselves to look into their pension systems, within the terms of three broad principles for securing their long-term sustainability:

- To safeguard the capacity of pension systems to meet their social aims of providing safe and adequate incomes to retired persons and their dependants and ensuring, in combination with health and long-term care systems, decent living conditions for all elderly persons.

- To ensure the financial sustainability of pension systems**,** so that the future impact of ageing does not jeopardise the long-term sustainability of public finances or the ability to meet fundamental goals of budgetary policy (in terms of overall tax burdens or spending priorities) and does not lead to an unfair distribution of resources among generations.

- To enhance the ability of pension systems to respond to the changing needs of society and individuals, thereby contributing to enhanced labour market flexibility, equal opportunities for men and women with regard to employment and social protection, and a better adaptation of pension systems to individual needs.

A comprehensive process has now been launched on all these issues, under a new co-ordination method called "open method of co-ordination"*,* which was introduced at the Lisbon Summit. It can be applied for co-ordinating Member States' policies in areas where legislative measures are not possible and where no processes previously existed. It was designed to help Member States to develop their own national policies towards the commonly agreed goals. New activities are launched to exchange information and best practices and to promote and evaluate innovative approaches. At the same time, it is also made clear that this new process takes its place alongside the existing, well-functioning EU processes and that it should not change the division of responsibilities between the European and national levels. In the field of social protection, harmonisation of national laws and regulations is strictly excluded, and unanimity of the Member States is always required for any legislation. This is applicable now (TEU Article 137) and will also apply after the entry into force of the Nice Treaty, which will extend qualified majority decisions to many other fields.

Once again, distinct from the above, in the field of public finances in general, the authority of the EU goes much further than in monitoring the financial sustainability of pension systems under the open method of co-ordination. Hence, under the Stability and Growth Pact, Member States may decide, with a qualified majority within the ECOFIN Council, to sanction a euro area Member State that has an excessive government deficit and fails to take the recommended corrective action. This situation could be caused by an imbalance in the pension system, thus requiring corrective measures to ensure its sustainability. However, the other features of the pension systems do not fall within the competence of the EU.

The process of implementation of the other two broad principles on pensions under the "open method of co-ordination" is now underway. The Member States committed themselves in the Laeken Summit in December 2001 to presenting national strategy reports in 2002 that will contain a diagnosis of major challenges and reform plans. The Commission and the Council will then jointly assess these

reports with regard to the broad common objectives, identify good practices and innovative approaches, and subsequently present a joint report to the European Council in Spring 2003.

Summary

Most of the current EU Member States and EU Candidate Countries have similar problems with ageing. It is already known that demographic trends, based on highly reliable projections, will lead to a sharp increase in pension expenditure. No single measure will suffice to cope with this pressure, but serious consideration should be given to a full range of pension reforms.

Social security, including pensions, is largely under the authority of Member States. Even so, here as elsewhere, the EU has a role to play in removing obstacles to the functioning of the internal market. Also, in monitoring the sustainability of public finances in each Member State, the EU looks for possible risks related to the long-term development of public pension expenditure, and in instances where such a risk exists, joint conclusions are drawn and recommendations submitted to the Member State in question. It is important for the smooth functioning of the Euro zone to implement a clear process for addressing pension financing problems as they arise. However, these requirements should not be seen as an added burden imposed by EU membership, inasmuch as public finances should obviously be sustainable for purely domestic reasons in all countries.

In addition to these aspects of the pensions systems, the EU has recently initiated a full-range discussion on pensions. Even if overall decisions on reforms and policies are taken at the national level, Member States can benefit greatly by learning from each other's experiences. Therefore, they have decided upon systematic reporting and joint assessment of measures to meet the challenges posed by ageing.

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Table 5.1. Public pension expenditures including all replacement revenues to people over age 55 before taxes (as a percentage of GDP)

						Peak*	
	2000	2010	2020	2030	2040	2050	change
Belgium	10.0	9.9	11.4	13.3	13.7	13.3	3.7
Denmark[1]	10.5	12.5	13.8	14.5	14.0	13.3	4.1
Germany	11.8	11.2	12.6	15.5	16.6	16.9	5.0
Greece	12.6	12.6	15.4	19.6	23.8	24.8	12.2
Spain	9.4	8.9	9.9	12.6	16.0	17.3	7.9
France	12.1	13.1	15.0	16.0	15.8	:	4.0
Ireland [2]	4.6	5.0	6.7	7.6	8.3	9.0	4.4
Italy	13.8	13.9	14.8	15.7	15.7	14.1	2.1
Luxembourg	7.4	7.5	8.2	9.2	9.5	9.3	2.2
Netherlands	7.9	9.1	11.1	13.1	14.1	13.6	6.2
Austria	14.5	14.9	16.0	18.1	18.3	17.0	4.2
Portugal	9.8	11.8	13.1	13.6	13.8	13.2	4.1
Finland	11.3	11.6	12.9	14.9	16.0	15.9	4.7
Sweden	9.0	9.6	10.7	11.4	11.4	10.7	2.6
United Kingdom	5.5	5.1	4.9	5.2	5.0	4.4	-1.1
EU-15	10.4	10.4	11.5	13.0	13.6	13.3	3.2

**Note*: Calculated from 5-year interval data.

1. For Denmark, the results include the semi-funded labour market pension (ATP). If the ATP is excluded, the peak increase would be 2.7% of GDP.

2. Results for Ireland are expressed as a percentage of GNP.

Source: Economic Policy Committee Report "*Budgetary Challenges Posed by Ageing Populations*", October 2001.

PART II

POLICY CHOICES AND CONSTRAINTS: RECONCILING SHORT-TERM AND LONG-TERM OBJECTIVES

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Chapter 6

REFORMING PENSIONS: MYTHS, TRUTHS AND POLICY CHOICES[1]

by
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Over 20 years ago, in a paper called "Myths My Grandpa Taught Me" (Barr, 1979), I addressed a particular myth − that funded schemes are less vulnerable to demographic pressures than Pay-As-You-Go (PAYG) schemes. Since then, a major debate has erupted about the necessity/desirability/urgency of a move towards private, funded pensions. This paper is a contribution to that debate, intended as a bridge between economic theory and policy design. The opening section sets out the simple economics of pensions. The second section discusses a series of surprisingly durable myths. The building blocks of reform are discussed in two parts: the third section draws together the conclusions for policy design of earlier theoretical discussion and sets out a series of prerequisites for *any* pension scheme; the existence of such prerequisites does not, however, mean that the choices facing policymakers are limited; the large range of choice is set out in the fourth section. Throughout the paper there is explicit discussion of how the arguments apply in different types of economies (although such discussion is intended neither as a survey nor as formal comparison, but to show how the analytics play out in different contexts).

The simple economics of pensions

Three themes recur throughout the paper: the centrality of national output; the pervasive risk and uncertainties faced by pension schemes; and the problems of imperfect consumer information.

The centrality of output

The economics of pensions can be confusing because it concentrates on finance. I shall try to simplify matters by concentrating on the core economic issue − the production and consumption of goods and services.

There are two (and only two) ways of seeking security in old age (Barr, 2001, Chapter 6). It is possible to *store current production* for future use. Though this was the only way Robinson Crusoe could guarantee consumption in retirement, the approach is inadequate: it is costly; it does not deal

1. Reprinted with permission from the *International Social Security Review*, Vol. 55, No. 2, April-June 2002. The material in the second section draws on my time as Visiting Scholar at the Fiscal Affairs Department at the IMF. I am grateful for the Department's hospitality and for helpful discussions with many people at the IMF and outside. The arguments in this paper are set out more fully in Barr (2001, Chapters 6-9), which integrates them within the broader microeconomic foundations of the welfare state; an earlier version (Barr, 2000) can be downloaded from the IMF Website. Responsibility for the views expressed and for remaining errors is mine.

with uncertainty (*e.g.* about how one's tastes might change); and it cannot be applied to services deriving from human capital, medical services being a particularly important example. Storing current production is thus not a promising approach.

The alternative is for individuals to exchange current production for a *claim on future production*. There are two broad ways in which I might do this: by saving part of my wages each week I could build up a pile of *money* which I would exchange for goods produced by younger people after my retirement; or I could obtain a *promise* − from my children, or from government − that I will be given goods produced by others after my retirement. The two most common ways of organising pensions broadly parallel these two sorts of claim on future output. Funded schemes, where pensions are paid from a fund built over a period of years from the contributions of its members, are based on accumulations of financial assets; PAYG schemes, where pensions are paid (usually by the state) out of current tax revenues, are based on promises.

Given the deficiencies of storing current production, the *only* way forward is through claims on future production. What matters, therefore is the level of output after I have retired. The point is central: pensioners are not interested in money (*i.e.* coloured bits of paper with portraits of national heroes on them), but in consumption − food, heating, medical services, seats at concerts, etc. Money is irrelevant unless the production is there for pensioners to buy.

Risk and uncertainty

It is important to distinguish risk and uncertainty. With risk, the probability of potential outcomes is known or estimable, with uncertainty it is not. The distinction is critical, among other reasons, because actuarial insurance can generally cope with risk but not with uncertainty.

Risk and uncertainty facing pension schemes. Pension schemes face both problems. There are at least three sorts of uncertainty:

a) Macroeconomic shocks affect output, prices or both. Since funding and PAYG are simply different ways of organising claims on future output, it should not be surprising (myth 1, below) that a fall in output adversely affects any pension scheme.

b) Demographic shocks, it will turn out, also affect all pension schemes.

c) Political risks affect all pension schemes because all depend critically − albeit in different ways − on effective government.

Alongside these common shocks, private funded schemes face further risks.

d) Management risk can arise through incompetence or fraud, which imperfectly-informed consumers generally cannot monitor effectively.

e) Investment risk: pension accumulations held in the stock market are vulnerable to market fluctuations. At its extreme, if a person must retire on her sixty-fifth birthday, there is a lottery element in the value of her pension accumulation.

f) Annuities market risk: for a given pension accumulation, the value of an annuity depends on remaining life expectancy and on the rate of return the insurance company can expect over those years. Both variables face not only risk but also significant uncertainties.

Risks facing individual pensioners. Given these uncertainties and risks, a separate question is how they are shared. With individual funded accounts (also called *defined contribution* schemes), the contribution rate is fixed, so that a person's pension is an annuity whose size, given life expectancy, etc., is determined *only* by the size of her lifetime pension accumulation. Thus the individual faces all the uncertainties, (a)-(c), and risks, (d)-(f), just discussed.

Under a *defined benefit* scheme, often run at firm or industry level, a person's pension is based on his wage and length of service. A key feature is the way wages enter the benefit formula. In older schemes, a pension was often based on a person's final salary. That arrangement, however, has distortionary effects on wages and labour mobility. The trend has therefore been to base benefits on a person's real wages averaged over an extended period. Whichever way wages are calculated, a person's annuity is, in effect, wage indexed until retirement. The employee contribution is generally a fraction of his/her salary. Thus the risk of varying rates of return to pension assets falls on the employer, and hence on some combination of the industry's current workers (through effects on wage rates), its shareholders and the taxpayer (through effects on profits), its customers (through effects on prices) and/or its past or future workers, if the company uses surpluses from some periods to boost pensions in others.[2]

With *social insurance*, risk is shared yet more broadly. The costs of adverse outcomes can be borne by the pensioner through lower pensions, by contributors through higher contributions, by the taxpayer, through tax-funded subsidies to pensions, and/or by future taxpayers through subsidies financed by government borrowing.

Imperfect consumer information

The advantages of consumer sovereignty assume that the individual is well informed. This is by no means always the case.

Individuals are imperfectly informed, first, because of *uncertainty* about the future in the face of the common shocks just discussed − individuals are not well informed, because nobody is well informed. Individuals are imperfectly informed, second, in the face of *risk*, for example about longevity. This is not a problem where risks can be covered by insurance.

A third type of imperfect information applies particularly to defined-contribution schemes. Private pensions are complex, based on an array of financial institutions and financial instruments. Even in the US, arguably the country with the greatest public knowledge of financial markets, there is considerable ignorance. Orszag and Stiglitz (2001, p. 37) quote the Chairman of the US Securities and Exchange Commission as stating that over 50% of Americans did not know the difference between a bond and an equity. Similarly, a report by one of the largest UK banks pointed out that "lack of investment growth is a significant risk even if the fund is secure. However, there is little evidence that this basic truth has been understood" (National Westminster Bank, 1997, p. 19). The problem has equity as well as efficiency implications, since the people who are worst-informed are disproportionately the least well-off − *i.e.* information poverty and financial poverty go hand in hand.

Some ignorance can be reduced by public education. However, some is inherent. Even financial sophisticates cannot necessarily be regarded as well-informed consumers.[3] Given the high potential

2. For detailed comparison of defined-benefit and defined-contribution schemes, see Bodie *et al.* (1988).

3. At a conference on strengthening the regulation of UK private pensions, a Professor of Finance concluded that she was not a well-informed member of the UK University teachers' pension scheme, nor even a *potentially* well-informed consumer.

cost of mistaken choice, imperfect information creates an efficiency justification for stringent regulation to protect consumers in an area where they are not well-enough informed to protect themselves. The Maxwell scandal (the illegal use by a failing UK firm of assets in its pension fund – see UK Pension Law Review Committee, 1993; UK Treasury Select Committee, 1998) illustrates the need to tighten regulation even in advanced industrial countries.

Misleading guides to policy

Like many myths, those discussed here may have an element of truth. On closer inspection, however, that element is either tenuous or based on restrictive assumptions, and is thus a misleading guide to policy. Some readers may regard these myths as caricatures that nobody takes seriously. However, I have come across all of them in recent policy debate. The following discussion examines three sets of myths, concerning the macroeconomics of pensions (myths 1-5), pension design (myths 6-9), and the role of government (myth 10).[4]

Myth 1: Funding resolves adverse demographics

"Some degree of pre-funding is desirable in an old-age security system. This helps to insulate the system from demographic shock" (James, 2001, p. 63).

Consider a balanced PAYG scheme, where:

$$sWL = PN \quad (1)$$

where s = the PAYG social security contribution rate

W = the average nominal wage

L = the number of workers

P = the average nominal pension

N = the number of pensioners.

In such a scheme, current contributions of the workforce exactly cover current pension payments.

To show the effects of adverse demographics, suppose that a large generation in period 1 is followed by a smaller generation in period 2. As a result, the smaller period 2 workforce has to support the large generation of retired period 1 workers. It is helpful to consider separately the cases of static output and growing output.

Static output. Suppose that, because of a decline in the birth rate, L halves. Other things being equal, a PAYG scheme can remain in balance in various ways. Halving the average pension, P, imposes the entire cost of demographic shock on pensioners. This is problematical, because it breaks past promises and risks pensioner poverty. Another option is to double the contribution rate, s, imposing the entire cost on workers. This is problematical, because of its potential adverse incentive effects. Other options are discussed shortly.

It is sometimes argued that funded schemes get round this problem: period 1 workers build up pension savings; the savings of a representative worker exactly cover his pension stream (*i.e.* the

4. For fuller analysis, see Barr (2001, Chapter 7), Orszag and Stiglitz (2001).

present value of his pension stream exactly equals the lump sum he has accumulated by the time he retires); if there is a large number of period 1 workers, this is not a problem, it is argued, because each worker accumulates enough to pay for his/her own pension.

The problem with this argument is demonstrated in Barr (1979). The key point is that the underlying problem caused by demographic change is a fall in output. This affects a PAYG system by shrinking the contributions base, WL. With funding the mechanism is more subtle, but equally inescapable, operating through a mismatch between demand and supply in either the goods market or the assets market. The mechanism merits explanation. Discussion starts with a closed economy; subsequent extension to a global economy does not change the result.

If a large generation is followed by a smaller generation, there will be a large accumulation of pension funds belonging to the older generation at a time when the workforce is declining. The older generation draws down its accumulated savings to finance its desired level of consumption in retirement. That desired spending will exceed the desired pension contributions of the smaller younger generation. If output does not rise, the resulting disequilibrium manifests itself in either of two ways.

a) Suppose that pensioners seek power over future production by accumulating monetary assets such as bank accounts or government bonds. In that case, desired pensioner consumption exceeds desired saving by workers. Excess demand in the goods market causes price inflation, reducing the purchasing power of period 2 annuities.

b) Suppose, instead, that pensioners accumulate non-money assets such as equities. In that case, desired asset sales by pensioners exceeds desired asset purchases by workers. Excess supply in the assets market reduces asset prices, reducing pension accumulations and hence the value of the resulting annuity.

Under either outcome, pensioners do not get the real pension they expect. Funded pensions face similar problems to PAYG schemes, and for exactly the same reason − a shortage of output. The only difference is that with funding the process is less direct and hence less transparent.

Growing output. Returning to equation (1), with static output the problems of PAYG could be resolved by halving P, by doubling the contribution rate, s, or by a combination of the two. An alternative solution arises where output, and hence the average wage, W, doubles, but P remains constant. Though this implies a fall in the replacement rate, P/W, pensioners − crucially − get the real pension they were promised.

Equally, increased output is a complete solution for funded schemes. Cases (a) and (b) now play out as follows:

a) Goods market: a decline in the savings rate at full employment increases aggregate demand; but if aggregate supply increases sufficiently, there is no excess demand and hence no inflation. Though P/W falls, period 2 pensioners get the real pension they expect.

b) Assets market: higher output generally implies higher wages; if period 2 workers want a pension of (say) 50% of their previous wage, their demand for assets to hold in their pension accumulation will increase in line with their wages. At its simplest, L halves but W doubles, so that the demand for assets equals desired sales by pensioners. Hence there is no deflation of asset prices. Again, period 2 pensioners get the real pension they expect.

Policies in the face of demographic change. Thus the central question − and the reason for the earlier emphasis on output − is how to encourage growth, and the part funding might play in bringing this about. In principle, output can be increased in two ways.

One approach is to increase the productivity of each worker, thus increasing W in equation (1). Policies include a) more and better capital equipment, and b) improving labour through education and training. A second approach is to increase the number of workers, thus increasing L in equation (1), for example, c) introducing policies to increase labour supply, d) raising the age of retirement, e) importing labour directly, *e.g.* through more relaxed immigration rules, and f) importing labour indirectly by exporting capital to countries with a young labour force.

What impact does funding have on these policies? The impact of funding on capital accumulation via policy (a) is controversial, a topic taken up in more detail below (myth 3).

The effect of funding on (f) requires discussion. Pensioners can consume goods made abroad so long as they can organise a claim on those goods. If British workers use some of their savings to buy Australian factories, they can in retirement sell their share of the factory's output for Australian money to buy Australian goods, which they then import to the UK. Though useful, this approach is no panacea. The policy breaks down if Australian workers all retire; thus the age structure of the population in the destination of foreign investment is important. Second, if large numbers of British pensioners exchange Australian dollars for other currencies, the Australian exchange rate might fall, reducing the real value of the pension. Thus the ideal country in which to invest has a young population *and* products one wants to buy.

Accumulating assets in countries with younger populations is thus one way to maintain claims on future output. Overseas investment by pension funds is one way to implement this policy. But there are other ways: I could, for example, hold part of my saving in Australian equities or mutual funds. Funding *per se* is not paramount − what is paramount is saving.

Whatever the arguments about policies (a) and (f), funding clearly has no bearing on output-increasing policies (b)-(e). The conclusion to which this leads is threefold:

1. In the face of demographic problems, the key variable is output.

2. Policy should consider the entire menu of policies that promote output growth directly.

3. From a macroeconomic perspective the choice between PAYG and funding is secondary.

Thus the argument that funding insulates pensioners from demographic change should not be overstated. From an economic point of view, demographic change is not a strong argument for a shift towards funding.

Myth 2: The only way to pre-fund is through pension accumulations

Since population ageing is known long in advance, it is desirable to have a long-term planning horizon. Moving towards funded pensions is one such move. It is not, however, the only one.

Government can finance higher future pension spending by reducing other future public spending. One way is to pay off some public debt now. Rising pension expenditure will thus at least partly be offset by lower debt-servicing expenditure.

Second, government can set aside resources now to meet future demands. Norway puts part of its oil revenues into a fund to smooth taxes in the face of demographic change; similarly, the US has a Trust Fund partly to cover future pension spending. However, unless such actions increase output these mechanisms are a zero-sum game between consumption by pensioners and workers.

Thus, if pre-funding is thought desirable, it does not follow that a move towards private pensions is the only way of doing so.

Myth 3: There is a direct link between funding and growth

It is often regarded as self-evident that saving, and hence economic growth, will be higher with funding than under PAYG. "The core rationale for the multi-pillar recommendation ... [includes] funding to increase national saving" (James, 2001, p. 63). However, the link between funding and growth faces several major qualifications.[5]

First, increases in saving, if any, occur only during the build up of the fund − in a mature scheme, saving by workers is matched by payments to pensioners. Second, saving does not *necessarily* increase, even during the build-up phase. First, increases in mandatory saving may be at least partly offset by reductions in voluntary saving (see, for example, Gale, 1998). Second, a central question is what happens to the pensions of the older generation. If they are reduced, consumption falls, and hence, *cet. par*., savings will indeed rise. But if pensions are not reduced, they have to be paid from taxes or government borrowing. Extra taxation exerts downward pressure on saving; extra borrowing at least partially offsets additional private capital formation. These macroeconomic effects could swamp moves from PAYG to funding. It is therefore not surprising that an IMF study (Mackenzie, *et al*., 1997, p. 1) concluded that,

> "[s]tudies of the US economy, on which most research has been done, provide some moderately strong evidence that the introduction and development of the public pension plan have depressed private sector saving, although the extent of this impact has proved hard to estimate. Studies of other countries as a group have tended to be inconclusive..."

A third qualification is that saving does not necessarily lead to new investment: a British trade union once famously invested part of its pension fund in old masters. Fourth, increased investment does not *necessarily* increase output: investment in the latter days of communism was high, but growth low or even negative. Even in well-run economies, it cannot simply be assumed that pension fund managers make better choices than other agents in channelling resources into their most productive use.

A separate line of argument is that funding contributes indirectly to growth by widening and deepening capital markets. As Diamond (1995) points out, though not an argument that applies to the OECD member countries, it applies to transition and developing countries. However, the broader context is important: though a larger capital market may be a *component* of growth, it is not on its own a solution. A key lesson from Chile (to which the capital-market-development argument is often applied (Holzmann, 1997) is the effectiveness of reform outside the financial sector.

To summarize a large, complex and controversial literature:

5. See Barr (2001, Chapter 7), Thompson (1998), Mackenzie *et al.* (1997).

- The magnitude of the impact of funding on growth is controversial. Though there is some evidence that funding contributes to higher savings in the US, there is no robust evidence of a similar effect elsewhere; and even the US evidence is controversial.

- The issue, in any case, relates only to one of the sources of growth. Hence policies concerned with growth should consider the *entire* menu of policies discussed earlier.

- Though growth is important, the primary objective of pensions is old-age security. As Mackenzie, Gerson and Cuevas (1997, p. 1) point out, "It can hardly be over-emphasized that the basic objective of a public pension programme is not to raise the savings rate, but to provide income security − at the very least, a minimum income − for the elderly".

Myth 4: Funding reduces public pension spending

Though private pensions can reduce public pension spending in the longer term when they are mature, they increase short-term budgetary pressures. If workers' contributions go into their individual pension accounts, they cannot be used to pay for the pensions of the older generation; thus, governments must finance pensions for the transition generation through taxation or borrowing.

Furthermore, the costs of privatising a bloated PAYG system are greater than those of privatising a sustainable scheme. An important conclusion follows: privatisation is no solution to fiscal problems. *If a state scheme is unsustainable, the only solution is to make it sustainable* by increasing contributions, by cutting benefits or by a mixture of the two. A move towards funding, whatever its other merits, should not be undertaken to reduce short-run spending.

Myth 5: Paying off debt is always good policy

The argument runs as follows.

a) Members of a PAYG scheme have accumulated rights.

b) Those rights are an unfunded liability and hence can be thought of as implicit debt.

c) The scale of that debt is large; fiscal prudence therefore suggests that it should be reduced.

d) A move towards funding achieves this. The state requires younger workers to join funded schemes and pays the pensions of the older generation through taxation or borrowing. Such expenditure ceases once the older generation has died; accumulated debt, if any, is repaid by current and future taxpayers.

e) Hence a move towards funding is desirable because it reduces implicit debt.

In considering these arguments (for fuller evaluation, see Barr, 2001, Chapter 7), the underlying question is whether paying off debt is always desirable. More generally, should all anticipated future needs be pre-funded? I know that I will need to buy food for the rest of my life, but I do not accumulate a food fund, intending instead to pay my supermarket bills out of my future earnings. The reason for building a pension accumulation is different − namely, that I intend to retire, *i.e.* to stop producing goods that I can exchange for other goods. No such accumulation is needed in a world without retirement, *i.e.* where people are immortal, or remain active in the labour force until their death. Such a world is mythical for the individual, but is exactly the case for a country, which does not

have to take action to anticipate a time when production will cease. The fact that countries are immortal is central: from an economic perspective, it makes pre-funding unnecessary unless it has a positive effect on output, about which, as discussed earlier, the arguments are equivocal.

Moreover, if the worry is the state's unfunded liabilities, why is the argument applied only to pensions? In all but the poorest countries, health care and education are largely publicly funded. Governments do not willingly break promises (which can be constitutional guarantees) to care for the sick and to educate the country's children. Such commitments are implicit debt just like pensions, and their scale is not dissimilar, yet there is no discussion of pre-funding.

If pre-funding does not increase output, its benefits are unclear. If I have savings of $20 000 and debt of $5 000, my net worth is $15 000. If I repay the debt, my savings fall to $15 000; my net worth remains $15 000. Repaying debt does not change my net wealth, but does mean that I have to tighten my belt. If there is no need to repay, the welfare gains from doing so are unclear.

This line of reasoning suggests two conclusions. First, what matters is not the gross magnitude of future liabilities but their sustainability. Second, the case for minimising debt is not strong; here − as elsewhere − its scale should be optimised, not minimised.

Myth 6: Funded schemes have better labour market incentive effects

"The core rationale for the multi-pillar recommendation [includes] ... defined contribution to provide good labour market incentives, especially regarding the age of retirement" (James, 2001, p. 63). Labour market distortions are minimised when contributions bear an actuarial relationship to benefits. Private pensions may have these characteristics, but so do state schemes which pay benefits proportional to contributions. In contrast, badly designed schemes − whether public or private − can encourage early retirement (see Gruber and Wise, 1999); and many employer schemes encourage labour immobility (public schemes, being universal, do not have this problem). The bottom line is that labour supply depends on pension design, not on whether a scheme is private or public.

Separately, this argument implicitly assumes that all that matters is labour supply. Analogous to earlier arguments about saving, however, what matters is not labour supply but economic welfare. It may be, for example, that a defined-benefit scheme reduces labour supply at the margin; but if the loss of utility resulting from lower output is more than offset by the utility gain from greater security, defined-benefit arrangements may be welfare improving, even if they do reduce labour supply.

Myth 7: Funded pensions diversify risk

"The principal advantage of a multi-pillar pension scheme lies in risk diversification. Not all of the population's retirement portfolio will be held hostage to political and demographic risk" (Holzmann, 2000, p. 21).

The various risks and uncertainties facing pensions were discussed earlier. PAYG and funded schemes are both vulnerable to macroeconomic shocks. They are also both vulnerable to demographic shocks (myth 1). And, as discussed in myth 10, both depend critically on effective government, and are therefore vulnerable to political shocks.

Private pensions face additional risks. First, there is management risk. Management may be honest but incompetent, or deliberately fraudulent. Thus pension funds require regulation to protect consumers. Second, there is investment risk. Under a defined-contribution scheme, two people with identical earnings histories may end up with very different pensions. "Benefits depend on the returns

on assets (which are stochastic and with the right stochastic process in dispute) and on the pricing of annuities (which is also stochastic and also subject to dispute...)" (Diamond, 2001, p. 76). Burtless (2002) compares workers who differ only in the year in which they retire, and finds substantial variations – *e.g.* a replacement rate of 80% for someone retiring in 1972 collapsed to just over 40% for someone retiring in 1974. Miles (2000), using European data, concludes that "some age cohorts would earn very low, and possibly, even negative returns.... These findings on the risk faced by pensioners are at odds with the position taken in much of the literature, and suggest that the benefits of funded schemes tend to be overstated" (Royal Economic Society, 2000, p. 13). Reducing these risks, though possible and desirable, however, is a zero sum game: it does nothing *per se* to increase output; thus the gain in pensioners' consumption from selling their accumulations at the top of the market is at the expense of workers' consumption.

Finally, there is annuities market risk. A person who retires when interest rates are low will receive a lower annuity. In Chile,

> "The collapse of long-term interest rates ... has had a dramatic effect on annuity rates. By way of example, 100,000 units of capital would have secured a life-long annuity of 8,000 per annum in July 1998. For the same 65-year old man, by October 1998, 100,000 units of capital would only have secured an annuity of 5,800 per annum" (Callund, 1999, p. 532).

These arguments suggest two conclusions. First, the risk-spreading argument is more complex than it appears: private pensions may or may not diversify risk; they certainly introduce additional risks. Second, if we *do* accept the argument, we should be clear that it is as much a defence of the state pension as of private pensions.[6] Thus the risk-diversification argument is logically incompatible with the view (World Bank, 1994; James, 1998) that the first pillar should be minimised.

Myth 8: Increased choice is welfare-improving

Increased choice is desirable, but only where consumers are well informed (on the central role of information, see Loewenstein, 1999). However, as discussed in section 1, pensions are complex even for financially sophisticated consumers, and the problem is even more acute in poorer countries.

The cost of allowing choice, particularly administrative costs, is equally important. Constrained choice (*e.g.* in a state scheme) opens up the possibility of administrative economies of scale; those economies are lost in a system with individual accounts from competing providers. It may be argued that competitive pressures keep costs down, but as Orszag and Stiglitz (2001, p. 35) remind us, competition "only precludes excess rents; it does not ensure low costs. Instead, the *structure* of the accounts determines the level of costs" (emphasis in original).

The issue is important because the power of compound interest (one of the main arguments used in support of funded accounts) applies equally to administrative costs. The US Advisory Council on Social Security estimates that, under plausible assumptions, the *additional* administrative costs of a decentralised system absorb about 20% of the value of a pension accumulation over a 40-year career (Orszag, 1999, p. 33). Thus it should not be surprising (see Diamond, 1998) that Chile and the UK, both of which rely to a significant extent on individual accounts, have high administrative costs.[7]

6. Merton, Bodie and Marcus (1987) argue that a mixed system can reduce risk relative to a fully-funded system.

7. See also, the Report of the Panel on Privatization of Social Security, 1998, pp. 25-35.

Additionally, administration is largely a fixed cost, and thus bears most heavily on small pension accounts, again a point of immense significance in poorer countries.

Myth 9: Funding does better if real returns exceed real wage growth

It is often argued that funded schemes provide larger pensions than PAYG systems because stock market returns are higher than those offered by state schemes.

> "In contrast to the 2.6% equilibrium return on Social Security contributions, the real pre-tax return on non-financial corporate capital averaged 9.3% over the same ... period.... [As a result], forcing individuals to use the unfunded system dramatically increases their cost of buying retirement income" (Feldstein, 1996, p. 3).

However, a straightforward comparison between rates of return does not compare like with like. A fuller analysis needs to include the costs of the transition from PAYG to funding, the comparative risks of the two systems, and their comparative administrative costs. The following analytics draw on Orszag (1999), a non-technical summary of an important series of results originally established by Breyer (1989). The conclusion is that if proper account is taken of the costs of transition from a PAYG to a funded scheme the returns to the two schemes are equivalent.

Designing a system for a brand new world. The argument that pensioners are better-off under funding if the stock-market return exceeds real wage growth is, indeed, true in a brand new world. Mostly, however, what is being discussed is a move from an existing PAYG scheme towards funding. In that case, it is necessary to include the transition costs of the change.

Constant benefit rules; transition costs financed by public borrowing. In Table 6.1, taken from Orszag (1999), each generation pays \$1 in contributions when young and receives \$1 in pension when old. In period 1, the \$1 pension of older generation A is paid by the \$1 contribution of younger generation B. In period 2, when generation B is old, its pension is paid by the contributions of young generation C. Now suppose that the real rate of return on assets, *i*, is 10%, and imagine that we are generation C. Under a PAYG scheme, we pay \$1 in contribution in period 2 and receive \$1 pension in period 3; the real rate of return is zero. In contrast, with an individual account we save \$1 in period 2 and get back \$1.10 in period 3; the real rate of return, it appears, is 10%.

The flaw in the argument is that if generation C contributes to funded accounts, generation B's pension must be paid from some other source. If that source is government borrowing, generation C receives a pension of \$1.10 but has to pay interest of 10 cents on the borrowing which financed generation B's pension. The real return − as under PAYG − is zero. The lower return on the PAYG system is not the result of some inherent flaw, but is precisely the cost of the initial gift to generation A. Formally (see Breyer, 1989; Belan and Pestieau, 1999), there is an equivalence between the two schemes if the move to funding is considered not in isolation but alongside the cost of financing the change. Thus generation C is not made better-off by a move to individual accounts.

> "[F]alling money's worth in this model is *not* due to the ageing of baby boomers, increased life expectancy, or massive administrative inefficiency, but rather to the simple arithmetic of the pay-as-you-go system" (Geanakoplos *et al.*, 1999, p. 86, emphasis in original).

Constant benefit rules; transition costs financed by taxation. Suppose that we are generation C: in period 2 we put our contribution of \$1 into an individual funded account; but in this case the \$1 pension of generation B is paid out of a budget surplus. The pension we receive as generation C is

$1.10. The real return is 10% because, with tax funding, generation C and its successors do not have to pay interest on additional public debt.

Critically, however, we could achieve the same result by partially pre-funding the PAYG system. Suppose that in period 2, the $1 of generation C is paid as pension to generation B, and *in addition* $1 is invested in a social security trust fund. Generation C, and succeeding generations, receive a pension of $1.10, of which $1 is from PAYG financing, and 10 cents from the proceeds of the trust fund; the real return is 10%. The higher return does not result from any move to individual accounts but from the injection of an extra $1. "Paying back" the gift to the first generation makes it possible to increase the rate of return to subsequent generations.

No benefits to the transition generation. Another way to finance the transition is to throw generation B out of the lifeboat by not paying their pension at all. Generation C and onwards enjoy a 10% real return, but those gains are at the expense of generation B, on whom the entire cost of transition is concentrated. In this case, the cost of the gift to generation A is offset by the negative gift to generation B.

The fundamental point is that there is a zero-sum game between the first generation and subsequent generations. The burden of the gift to the first generation can be placed entirely on the transition generation of pensioners (generation B) by reneging on PAYG promises; or entirely on the generation of workers at the time of transition (generation C) by financing generation B's pension out of taxation; or by spreading the burden over succeeding generations by financing the transition through borrowing. It is possible to alter the time path of the burden, but not its total. Again, the only way out of the impasse is if a move towards funding leads causally to higher rates of growth, an issue on which, as discussed earlier, controversy continues.

Completing the comparison. The costs of financing the transition are one element in the comparison between PAYG and funding. A second element is risk, discussed by Geanakoplos, Mitchell and Zeldes (1999). The key point is that the real return both to PAYG and to funded schemes should be adjusted downwards to account for risk. In countries with effective government, the tax base is less volatile than the stock market and, to that extent, even at face value the gain from a switch to funding is less than it appears. Finally, the comparison should consider any difference in administrative costs.

The conclusion is *not* that a move to individual accounts is bad policy, merely that its desirability cannot be established by comparing the simple rates of return. Atkinson (1999, p. 8) points out that critics of the welfare state tend to consider its costs without taking account of its benefits.

> "The emphasis by economists on the negative economic effects of the welfare state can be attributed to the theoretical framework adopted ... which remains rooted in a model of perfectly competitive and perfectly clearing markets. [This] theoretical framework incorporates none of the contingencies for which the welfare state exists... The whole purpose of welfare state provision is missing from the theoretical model".

The point here is precisely similar: that the benefits from a move to funding should not be considered in isolation, but alongside the relevant costs. This is a point of which economists, of all people, should need no reminder.

Myth 10: Private pensions get government out of the pensions business

The importance of government is now recognised by the Washington Consensus. Effective government is essential, whichever approach to pensions is adopted. Government failure is most obvious with PAYG schemes built on fiscally irresponsible promises, coupled with an inability to collect contributions. Results include inflationary pressures and political instability. However, private pensions are also vulnerable. Fiscal imprudence leads to inflation that can decapitalise private funds; and inability to regulate financial markets creates inequity, and may also squander the efficiency gains which private pensions are intended to engender. As Thompson (1998, p. 22) puts it,

> "It is ... too early to know how effectively the new systems based on the defined contribution model will be insulated from irresponsible behaviour. Politicians are not the only people who are prone to promise more than they can deliver. The defined contribution model requires sophisticated oversight and regulation to ensure that one set of problems resulting from public sector political dynamics is not simply traded for a different set of problems derived from the dynamics of private sector operations."

Two other issues are relevant. It is sometimes argued that funded schemes are safer from government depredations than PAYG pensions. While governments can (and do) break their PAYG promises, they can equally reduce the real return to pension funds, by requiring fund managers to hold government financial assets with a lower yield than they could earn elsewhere, or by withdrawing or reducing any tax privileges (the UK budget of July 1997 is an example of the latter).

Separately, it is argued that political pressure to repair ravages to a state scheme is stronger than those to put right adverse outcomes in private schemes. Where there is an explicit government guarantee (as in Chile), that argument is obviously false. Though ultimately the matter is empirical, the argument might fail more broadly: the larger the share of the population with private pensions and the greater the fraction of pension income deriving from private sources, the greater the pressure on government in the face of disaster. If PAYG is argued to represent implicit debt, the analogous argument is that mandatory private pensions have an implicit state guarantee.

Effective government is critical: to ensure macroeconomic stability, which underpins PAYG schemes and protects pension accumulations from unanticipated inflation; and to ensure regulatory capacity in financial markets for reasons of consumer protection. There is an inescapable role for the state in pensions even if one distrusts politicians.

Pension design: essentials

When discussing pension design, it is useful to distinguish factors which apply to *all* reforms, over which policymakers have little choice (discussed in this section) from those features over which policymakers have explicitly to make choices (discussed in the next). Discussion is organised in this way not only for logical but also for operational reasons. When advising governments it is helpful to distinguish areas where advisers can legitimately thump the table (*e.g.* asserting that public pension spending must be compatible with economic growth), from those where they should tread carefully.

This section draws together the central conclusions for policy design emerging from the theoretical discussion and then turns to core prerequisites for effective reform.

Policy design: lessons from economic theory

The central variable is future output. As discussed at the start, the possibilities for storing current output till old age are limited. Thus the only way to organise pensions is through claims on future output. PAYG and funding are simply different financial mechanisms for organising such claims. Two implications follow. First, it should not be surprising that they fare similarly in the face of output shocks. Second, since future output is uncertain, *all* pension schemes face uncertainty.

There is a large range of policies to increase output. As discussed in myth 1, policies to increase output increase the productivity of each worker, thus increasing W in equation (1), or increase the number of workers, thus increasing L. Policies of the first sort include a) more and better capital equipment and b) improving the quality of labour through education and training. Policies of the second sort include c) policies to increase labour supply (better child care facilities, taxation which supports part-time employment), d) raising the age of retirement, e) importing labour directly, and f) importing labour indirectly by exporting capital to countries with a young population.

A range of policies can contain fiscal pressures. The fiscal position can be improved by reducing future spending, PN in equation (1). Excessive reliance on reducing P may aggravate pensioner poverty and/create political pressures. A more desirable policy is to reduce N by raising the retirement age. This approach aims to keep taxation broadly constant, thus imposing the burden of adjustment on pensioners. A second approach seeks to finance higher future pension spending by reducing other expenditure. One way is to reduce public debt now, thus reducing interest repayments in the future. This policy levels up taxation to a point between present levels and those that would apply in the future in the absence of any policy change. The cost of change is thus spread across generations of taxpayers. Another approach is to set aside resources now, *e.g.* building up a surplus on the state PAYG scheme. The three approaches can, of course, be combined, for example paying off some debt to assist fiscal smoothing, and raising the age of retirement to share some of the burden with pensioners.

Demographic change creates problems but not insoluble ones. It follows that there is a large range of policies to contain demographic pressures. It is possible to:

- Increase output as above, thus increasing W in equation (1).
- Reduce the average pension, P.
- Increase the retirement age, thus reducing N *and* increasing L.
- Take steps now to reduce future non-pension spending, making it possible to increase s without any increase in overall taxation.
- Set aside resources now to meet future needs, thus avoiding the need to increase s. Policies under this head may include private pension accumulations.

The debate over PAYG and funding concentrates on a narrow part of the picture.

- From a macroeconomic perspective, the choice between PAYG and funding is secondary.
- The connection between funding and growth is controversial.
- The issue, in any case, relates only to one of the sources of growth.

Pensions design should take account of labour supply incentives. In contrast with debates about the incentive effects of pensions on saving and growth, the evidence on labour-market incentives is

strong. Badly-designed schemes − whether public or private, funded or PAYG − create adverse incentives, both during working life and in respect of the age of retirement. Pensions should avoid such incentives, both through good design and through policies to ensure that perceptions (for example of an actuarial relationship between contributions and benefits) accord with reality.

Implementation: prerequisites for reform

This section discusses the prerequisites for effective pension reform, summarised in Table 6.2, starting with public-sector prerequisites.

State pension promises must be fiscally sustainable. Beyond a certain point, the deleterious effects of high taxation are devastating, for example, the growth experience of the latter days of communism. Thus public spending, and within that public pension spending, must be compatible with economic growth. This does not mean that state pension spending in the long-run should be minimised, as opposed to optimised. The World Bank's 1996 *World Development Report* (Chapter 7) correctly talks about "rightsizing" government, and makes it clear that economies can function well with governments of different sizes − but only within fiscally sustainable limits.

Political sustainability has several ingredients. First, there must be sufficient strength of political will. Domestic ownership of reform is important, an aspect in which, it can be argued, the 1998 Polish reforms are on firmer foundations than those in Hungary.[8] Second, the duration of political support is important. Reform is not an event but a process. Reform does not end when the legislation is passed, but needs continuing commitment from government, both to ensure adjustments to reform proposals as events unfold, and for political reasons, to sustain continuing public support. Reform which is regarded as a once-and-for-all event runs the risk of neglect, discredit and eventual reversal. Third, the depth of political support is important. Understanding must go deeper than the top echelons of government, otherwise the original plan risks being implemented badly or, at worst, actively subverted by lower levels of government or administration.

The achievement of fiscal and political sustainability requires government capacity of the following three sorts.

Administrative capacity to collect taxes and enforce contributions. Public and private schemes require government to collect or enforce contributions. A country that cannot implement even a simple payroll tax cannot run a pension scheme. The issue then is how to organise poverty relief in a context of limited fiscal and administrative capacity (for a survey, see Ravallion, 1996).

The capacity to maintain macroeconomic stability is necessary to foster economic growth and for the long-run stability of PAYG finance. It is also critically important for private pensions, which are sensitive to unanticipated inflation.

Effective regulatory capacity. Effective regulation of financial markets is essential for private pensions, to protect consumers in areas too complex for them to protect themselves. This requires regulatory procedures *and* people with the capacity to enforce those procedures. The latter task is more difficult than it looks: because private pensions are complex, regulators need to be highly skilled − the sort of skills with a high price in the private sector. There are at least three strategic problems: that the regulatory regime collapses (or is ineffective); that the regulatory regime becomes *de facto* state

8. See Nelson (2000) for discussion of the politics of reform in Hungary; see also Góra and Rutkowski (1998) on Poland, and Simonovits (2000) and Augusztinovics *et al*. (2002) on Hungary.

control; or that the management and regulation of pension funds crowds out other demands for scarce human resources.

These public-sector prerequisites are relevant, for the most part, both to state and private schemes. Private pensions have additional private-sector prerequisites.

Adequate public understanding of and trust in private financial instruments. Private pensions require that government and citizens are well-informed about financial matters. In some less-advanced countries there is still a belief, even at high levels in government, that if a fund is "private" and the money "invested", a high real rate of return is inevitable, with no understanding of the nature of the risk. Nor is this a patronising remark about poorer countries. Earlier discussion made clear the depth of ignorance about financial institutions even in the UK and the US. Alongside knowledge about private finance is a separate issue of public trust. Specifically, does the public trust the private sector at least as much as it trusts government?

Financial assets and financial markets. Equally obviously, private schemes require financial assets for pension funds to hold and financial markets for channelling savings into their most productive use. One apparent solution − the use of government bonds as pension fund assets − is a blind alley. The resulting schemes are, in effect PAYG, since interest payments and subsequent redemption both depend on future taxpayers. Thus there is no budgetary gain, no channelling of resources into productive investment, and considerable extra administrative cost.

Another apparent solution is to use the pension savings of a poorer country to buy western financial assets. Bulgarian savings would go into (say) German firms, or Bolivian savings into US firms. The argument against this approach is that it foregoes the growth of domestic investment and domestic employment, which is part of the argument for private pensions. To get round this problem, it is argued (Kotlikoff and Seeger, 2000) that poor countries should buy low-risk western assets, offset by an inflow of western capital able to accommodate high-risk investments. The problem with this approach is the poor fit between capital inflows (frequently short-term) and the longer-term investment needs of a poor country (for fuller discussion, see Barr, 2001, Chapter 8). Thus the prerequisites of financial assets and financial markets really *are* prerequisites.

Private-sector capacity. First, is private capacity adequate? If not, high administrative costs will erode the return to pensioners, an issue that is of particular concern for small pensions. At worst, deficient administrative capacity puts at risk the viability of private funds. Second, even if private capacity is adequate, are private pensions its most welfare-enhancing use?

Table 6.2 summarizes the essential prerequisites, and serves as a check-list for policymakers contemplating pension reform and a guide to commentators assessing actual or proposed reforms. In meeting these prerequisites, advanced transition countries like Poland and Hungary have the capacity for the sort of sophisticated reforms they are proposing.[9] It was precisely because of the demonstrable

9. Progress in Poland has been rapid. In January 1990, I was faced with a radical pension privatisation proposal at a time when the monthly inflation rate was 80% and when – since there were no financial markets – there was no financial market regulation. At the time I wrote in a World Bank report: "[T]he need to restructure the state pension scheme [in Poland] is urgent .... Private pensions, in contrast, raise major issues which require detailed study ...; moreover, the time scale ... is longer term. For both reasons, this chapter seeks only to set out some of the central issues. Up to a point it indicates potential problem areas. The reason is not to discourage ... appropriately designed complementary private schemes, but to counter excessive optimism ... about how much can be achieved, and how soon.... The general thrust of the recommendations is that, over the medium term, the system of pensions should evolve into a system with three elements: a basic, state-run social insurance pension;

failure to meet several of the prerequisites that in 1998 the World Bank − courageously but correctly − withdrew its support for proposals to bring in mandatory second tier private pensions in Russia. Reference to the same criteria calls seriously into question reforms in Kazakhstan, which introduced private, funded pensions, based largely on government bonds.

Pension design: policy choices

Building blocks

What are the choices facing policymakers? A widely-publicised study (World Bank, 1994) "recommended a multi-pillar pension system − optimally consisting of a mandatory, publicly managed, unfunded pillar and a mandatory but privately managed funded pillar, as well as supplemental, voluntary, private funded schemes ... [W]e still conclude that the multi-pillar approach ... is the correct one" (Holzmann, 2000, pp. 12-13).

Taking a step back, the objectives of pension systems are threefold: poverty relief, consumption smoothing, and insurance. Rational policy design starts by agreeing objectives and then discusses instruments for achieving them. The problem with the World Bank analysis is that its categorization starts from instruments rather than objectives, and thus presupposes the choice, and to some extent also the mix, of instruments.

I shall categorize pensions in terms of objectives, to avoid such presupposition. The first tier pension is intended primarily to provide poverty relief. It is mandatory. Though normally publicly organised and PAYG, its form can vary widely. The second tier provides consumption smoothing; it can be publicly or privately managed; it can be funded or PAYG; and it may or may not be integrated into the first tier. The third tier is private, funded and voluntary, intended to enlarge individual choice. This categorisation deliberately uses the word "tier" rather than "pillar" because it is linguistically more apt: pillars are effective only if they are all in place and all, broadly, of the same size; tiers, more appropriately, are additive, in whatever constellation one wishes.

The following questions about pension design far from exhaust the list.

How large a first tier? Should the first tier be a guarantee or a base on which other pension income builds? It could be a state guarantee to individuals in private schemes, as in Chile, whereby only the least-well off receive any state pension. Or it could be awarded on the basis of an affluence test (*i.e.* withdrawn from the best-off), as in Australia. Or it could be flat-rate (hence going to all pensioners) at below the poverty line (many poorer countries), equal to the poverty line (broadly the UK), or above the poverty line (New Zealand). Whatever the design of the first tier, a minimum income can be guaranteed through income-tested social assistance (most OECD member countries).

How redistributive should the first tier be? There is less redistribution the smaller the pension and the greater the proportionality between contribution and benefit. Pensions strictly proportional to contributions bring about no redistribution between rich and poor (except for the greater longevity of richer groups). Such proportionality can be achieved through flat-rate pensions financed by flat-rate contributions, or where both pension and contributions are proportional to earnings. A flat-rate pension financed by a proportional contribution will be more redistributive, and financed from progressive general taxation more redistributive still.

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a mandatory system of appropriately regulated complementary private pensions; and a system of voluntary private pensions. The balance between the three elements should be a matter for public debate" (World Bank, 1993, para. 277). By 1998 the time for reform was right.

Should there be a second tier pension? The second tier pension provides consumption smoothing. A libertarian approach argues for mandatory membership only for poverty relief (see Barr, 1998, Chapter 6, for fuller discussion), *i.e.* a minimal first tier plus a voluntary, private third tier. The arguments for a mandatory second tier pension are familiar: as a merit good (*i.e.* paternalism); because imperfectly-informed younger people will make suboptimal choices from the perspective of their lifetime as a whole; to ensure insurance against unknowable events;[10] or to avoid moral hazard in the presence of a generous first tier pension.[11] The issue has a significant normative dimension (see Agulnik, 2000). If the second tier is mandatory, a consequential question is whether compulsion should be applied only up to some ceiling and, if so, what ceiling.

Should a second tier pension be PAYG or funded? In the USA, the first and second tier pensions are rolled into one, both mainly PAYG. In Canada, a first tier state pension provides poverty relief and a mandatory, publicly-organised, PAYG second tier pension provides consumption smoothing. Other countries, *e.g.* Australia and several in Latin America, have privately-managed, funded, mandatory second tier pensions. The UK has a mixed system.

Should the second tier be defined-contribution or defined-benefit? The issue here is how broadly risks should be shared. As discussed in Section 1, defined contribution schemes leave individuals facing the risk of differential pension fund performance. Individuals may also face the inflation risk, though this can be shared with the taxpayer if the state provides indexation. Occupational schemes are often defined-benefit, thus sharing risks more broadly.

Should the second tier be managed publicly or privately? The second tier is publicly-managed in some countries, *e.g.* the PAYG schemes in the USA and Canada. Singapore has a publicly-managed funded scheme. Many other countries, including Australia and Chile, have privately-managed second tier pensions.

Should opting out of state arrangements be allowed? The first tier pension, which is redistributive, is by definition mandatory. Beyond that, should people be allowed choice between consumption smoothing via a state pension or through private arrangements? In the UK, people can opt out of the state earnings-related pension and join a private scheme. In North America, in contrast, membership of the state earnings-related scheme is compulsory. Part of the argument against opting out is the possibility of adverse selection; the argument in favour is greater individual choice.

To what extent does the state assist with indexing pensions? Once a person has retired, pensions based on an annuity are vulnerable to inflation. A major question, therefore, is whether government protects pensions against inflation, and through what mechanism. Such participation by government introduces an unfunded element into funded schemes.

Fitting the pieces together

Pension design is controversial. Of the questions asked above, controversy swirls in particular round two questions: should the first tier, mandatory, state PAYG pension be minimal or substantial; and how should the second tier be organised — in particular, should it be mandatory, private, funded and defined-contribution?

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10. This is particularly an argument for social insurance, which can address uncertainty as well as risk.

11. The argument is that if there is a minimum guarantee, low-income people will have little incentive to make voluntary provision.

The scale of the disagreement is illustrated by the following two quotes.

- "The first pillar resembles existing public pension plans, but is smaller and focuses on redistribution – providing a social safety net for the old, particularly those whose lifetime income was low ... [T]his pillar is of limited scope.

- "The second pillar ... links benefit actuarially to contributions in a defined contribution plan, is fully funded, and is privately and competitively managed.

- "A third pillar, voluntary saving and annuities, offers supplemental retirement income for people who want more generous old-age pensions" (James, 1998, p. 275).

In contrast, in the context of the reforming post-communist countries, Eatwell *et al*. (2000, pp. 140-141) argue:

> "Clearly there is no *ideal* model for pension reform. [H]owever, the arguments developed earlier indicate the following course as being ... the best approach for a country that has inherited a non-sustainable PAYG system:

- Scaling down generosity towards pensioners...;

- If there is a positive political assessment of the net advantages of a FF [fully funded] system, [this argues for] its introduction ...;

- The promotion of a third pillar of voluntary private savings....

> "The end result is a potential three pillar system, apparently similar to that advocated by the World Bank (1994) ... The third pillar of voluntary savings is, of course, always actually or potentially present ... and cannot be considered as a distinctive feature of any reform. There are, however, very substantial differences between the recommendations listed above and those of the World Bank (1994) in that here:

- The first pillar is strengthened and maintained in its own right and with its own function...;

- A FF component is introduced not as a technically superior solution but as a primarily political, though entirely respectable, solution ...".

In many ways, the potential range of choice is even wider. Even if each of the issues in the previous section is taken as a simple yes/no choice, the eight questions yield 256 possible combinations. The following thumbnail sketches are intended not as a survey, but as illustrations of the wide range of schemes in the OECD and other successful economies (for somewhat fuller discussion, see Barr, 2001, Chapter 8 and the references therein).

Chile. Pensions in Chile were privatised in the early 1980s. Employees must join an individual private, funded, defined-contribution scheme, with a state guarantee where a worker with 20 or more years of contributions has only a low pension. Thus the second tier is a mandatory, privately-managed, individual funded account, with a residual first tier in the form of a guarantee. The Chilean reforms are widely-discussed (see Diamond, 1996; Callund, 1999). They are also controversial. To some, they are

seen as a beacon of hope (World Bank, 1994); others are more sceptical (Beatty and McGillivray, 1995).

Singapore. Workers and employers contribute to a Central Provident Fund (Asher, 1999) run by the government, which offers consumption smoothing not just for old age, but also for housing and medical expenditures. As such it offers no guarantee of old-age security. Singapore, like Chile, thus relies on a defined-contribution second tier pension. In sharp contrast with Chile, however, the fund is publicly-managed.

Sweden introduced a "notional defined-contribution" scheme in 1998 (Sweden: Federation of Social Insurance Offices, 1998). Its key feature is that the scheme remains mostly PAYG, financed through social insurance contributions. However, the pension a person receives bears a strict actuarial relationship to her notional lifetime pension accumulation (the amount being adjusted for the cohort's life expectancy). In addition, there is a safety net pension for people with low lifetime earnings and credits for periods spent caring for children.

Thus Sweden has a defined-contribution scheme with a safety net guarantee, and hence is a publicly-organised, PAYG analogue of Chile. This illustrates something that is often overlooked − that there is much flexibility *within* PAYG schemes. It might be argued that the Swedish approach risks government failure. However, it also avoids the risks specific to defined-contribution schemes; and though the scheme is individualistic in that it is defined-contribution, various credits (*e.g.* for caring for young children) introduce a collective element; finally, being PAYG, the scheme avoids the transition costs of a move to funding.

Australia is like Chile, in that its second tier pension builds on mandatory individual funded accounts, but unlike Chile in that it has a much more fully-articulated first tier. The distinctive features of the latter are that it is paid out of general taxation, and is subject not to an income test (designed to restrict benefits to the poor), but to an affluence test, which has the more limited purpose of clawing back benefit from the rich.

New Zealand has a generous universal flat-rate pension (about 65% of average weekly earnings) financed through general taxation, supplemented by voluntary, funded, defined-contribution pensions. There is discussion of a public fund partially to cover future pension spending. In a referendum in 1997, a proposal to move to a Chile-type system was heavily defeated (in an 80% turnout, 91.8% of voters rejected the proposal).

The UK has a flat-rate PAYG basic state pension. Under a 1980 reform, the pension was tied to changes in prices rather than wages; as a result, the basic pension is below the poverty line. Superimposed on the basic pension is mandatory membership of a second tier pension, which can be the state earnings-related scheme or a private scheme.

The USA has an earnings-related PAYG state scheme which is generous, relative to a minimalist view, though not in comparison with a number of European countries. Though people can retire earlier, full pension is paid when a person retires aged 65, rising gradually to 67. Many people also belong to a company or industry pension scheme and/or to an individual defined-contribution pension, such membership being voluntary so far as government is concerned. The US state scheme thus embraces both first and second tier pensions. Private schemes form a voluntary third tier.

Conclusion

This paper distinguishes three sets of factors:

- Those things which, for the analytical reasons set out in the second section, should be asserted only with caution.

- Those things that can − and should − be asserted authoritatively, notably the prerequisites for effective reform set out in the third section.

- Those areas, discussed in the fourth section, where − subject to the various prerequisites − there is room for considerable variation in the way countries organise their pension systems.

The following conclusions emerge:

- ***The key variable is effective government***, which is a prerequisite for well-run pensions, however they are organised (Ross, 2000, reaches a similar conclusion). It is not possible to get government out of the pensions business.

- ***From an* economic *perspective, the difference between PAYG and funding is second order***. There may, however, be political-economy differences (Cooley and Soares, 1999). It is argued, for example, that the political economy of raising the retirement age may be easier with a private scheme. In contrast, it is argued that a state scheme, which combines poverty relief and consumption smoothing, by embracing middle-class voters, will retain electoral support. Whatever the political arguments, the gains in terms of economic welfare of one pension arrangement as opposed to another are equivocal. Since PAYG and funding, as discussed earlier, are simply different financial mechanisms for organising claims on future output, this should not be surprising.

- ***A given set of objectives can be achieved in different ways***. There is no one:one relationship between instruments and objectives. Consider a scheme whose objectives include actuarial, mandatory consumption smoothing, with a safety net provision. The aim in this case is to have a fairly strict separation of consumption smoothing and poverty relief. In such a scheme, redistribution occurs only through the poverty-relief component. Chile pursues these objectives through competitive, privately-managed individual funded accounts, with a residual government guarantee, Sweden through a publicly-organised PAYG notional defined-contribution scheme with a safety net provision. In major respects, therefore, the Swedish scheme is a public-sector analogue of Chile's private arrangements.

- ***The range of potential choice over pension design is wide***. The key message of the previous section is not merely that one size does *not* fit all − which was always a foolish proposition − but that, provided government is effective, there is a considerable range of choice.

- The state pension should be *optimised*, not *minimised*. It can be smaller, as in Chile, which has a minimum guarantee, or the UK, where it is close to the poverty line, or larger, as in the USA. It can be income-tested (Chile), affluence-tested (Australia), flat-rate (New Zealand), partially earnings-related (USA) or fully earnings-related (Sweden). In poorer countries, fiscal constraints point to a relatively small state pension; as countries become richer, their range of choice increases.

- Consumption smoothing can be organised through a state PAYG scheme (Sweden), a state-organised funded scheme (Singapore), a mixture of state PAYG and private, funded schemes (the UK or USA) or almost entirely by private institutions (Chile, Australia). Such pensions can be occupational, defined-benefit (often in the UK) or individual defined-contribution (Australia). In developing economies, capital markets tend to be less well-developed, the capacity to regulate weaker, and the population less well-informed; with economic and institutional development, the range of choice widens.

- That wide range of choice, however, does not mean that countries can pick and mix at will.

- Countries with mature PAYG systems that face population ageing should adopt the range of measures discussed earlier. The core policies a) increase output and b) reduce the generosity of PAYG pensions, for example by raising the retirement age. Prefunding could be one element in the policy mix.

- Countries with large, unsustainable PAYG systems have little choice: the *only* solution is to make the PAYG system sustainable, by reducing benefits, by increasing contributions, or by a mix of the two. Since privatising a PAYG scheme is much more expensive when it is bloated, making the scheme sustainable is essential whether or not policymakers wish to move towards funded arrangements.

- Countries with limited institutional capacity also have little choice. There is a significant element of progression. In the poorest, administratively weakest countries the issue is how to organise poverty relief; as taxable capacity increases the next step might be a tax-funded citizen's pension; growing public administrative capacity makes it possible to implement a contributory system; with rising income and growing private administrative capacity, private pensions become an option.

- A country with a small public system and relatively solid public and private administrative capacity has the greatest potential choice. Provided it meets the prerequisites discussed earlier there is a genuine choice of balance between PAYG and funded arrangements. This paper has argued that from an *economic* point of view there is no dominant policy. That being the case, the right choice for a country is that which accords best with the political economy of effective reform. This, in turn, will depend on country specifics.

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Table 6.1. A simplified pay-as-you-go system

Period	Generation			
	A	B	C	D
1	+$1	-$1		
2		+$1	-$1	
3			+$1	-$1
4				+$1

Source: Orszag (1999, p. 9).

Table 6.2. Prerequisites for pension reform

	Essential for state scheme	Essential for private schemes
Public-sector prerequisites		
Fiscal sustainability of state scheme	√	
Political sustainability of pension reform package	√	√
Administrative capacity to enforce taxes/contributions	√	√
Capacity to maintain macroeconomic stability	√	√
Effective regulatory capacity		√
Private-sector prerequisites		
Sufficiently well-informed population		√
Financial assets		√
Financial markets		√
Adequate private-sector capacity		√

Source: Author for the OECD.

Chapter 7

FAIRNESS ACROSS GENERATIONS REQUIRES PARTIAL FUNDING

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The presentation by Nicholas Barr provides us with a useful discussion on the controversies over pension reforms. While I agree with many of his views and results, there also are some important aspects that I see in a different light.

Let's first take some aspects where we find common ground. We agree that some of the arguments for moving from pay-as-you-go (PAYG) to funding are either misguided or inadequate. One is the view that funding is beneficial, as the rate of return on contribution payments in the funded system is higher than in the PAYG, as (normally) the rate of return on financial assets is higher than the rate of change of the wage rate. This argument has now been shown to be inadequate. The difference between these two rates can be seen to reflect the implicit interest paid by the current and future generations on the implicit pension debt accumulated during the introduction of the PAYG system, when some past generations received benefits while not (fully) contributing to anybody's pensions themselves. Under certain assumptions, continuation of the PAYG system can be a fair arrangement to distribute this past burden across the current and all future generations – what the past generations paid and received is history, and there is no way to change what happened.

The second argument for funding, which we both view with a critical eye, is that under funding, the labour market is supposed to be undistorted, while under PAYG public systems it is. It is often argued (or just implicitly assumed) that this is the case, as under funding people understand that pension contributions are collected to be used for their own future pensions, while under PAYG the contributions are simply perceived as a tax on labour and hence cause a misallocation of resources and a loss in total welfare. We can certainly agree that, in reality, there is a difference in this respect between the two kinds of systems, but for an analytically correct argument and careful design of pension reforms, it should be clearly stated that the link between contributions paid by an individual and his/her benefits can also be made firm without introducing funding. A transition to a notional defined contribution (NDC) system, as implemented in Sweden, Latvia and Poland, is a case in point, and a proof that labour market distortion and transition to funding are two separate issues.

1. Views expressed are exclusively those of the author and should not be attributed to the European Commission.

As indicated by my comments above, I agree with Nicholas Barr that quite a few arguments in the literature on pension reforms are either myths, are less than totally convincing, or are controversial, to say the least. This leaves the way open for any number of views, without much hope for firm policy advice with respect to moving to more funding of pensions. This is where my ongoing work attempts to provide help. Below, I give a brief summary of the main points presented in a recently published paper (Oksanen, 2002).

Fairness calls for pre-funding of a defined benefit system

The objective that I deliberately emphasise is fairness of distribution of income between successive generations under ageing. I do not attempt to tell people what they should consider to be fair, but rather, provide a simple benchmark for measuring fairness, so that they can formulate their own view.

The starting point is a simple one: assume a unfunded defined benefit (DB) PAYG system; if the replacement rate (pension as a percentage of wage) and retirement age are assumed to remain constant, then under ageing, pension expenditure increases and therefore future generations have to pay more for the same benefits (in relation to wages). As ageing is partly caused by low fertility, it is obviously unfair that the generation that initiated low fertility should escape the increasing contribution rates. Instead, if we assume for the moment that the fertility rate remains constantly low, they should pay the same contribution rate as all following generations.

In parallel, if longevity increases and retirement age remains constant, it is fair that those who will live longer pay into the pension system more than what goes currently out as pensions, so that contribution payments reflect the expected increase in the years in retirement.

Implementation of these simple principles, based on stylised figures on fertility and longevity in the European Union Member States, means that for 30 to 40 years from now, contributions to the public pension system should exceed pension expenditure. This creates a fund, which provides proceeds to complement pension contributions, thus reducing the burden to be borne by future generations. Rough numbers indicate that pension contribution rates should increase by over half of their current levels, and the resulting fund should reach over 150% of GDP in the next 60 years.

The size of the projected fund indicates that it would be substantive by any measure. The order of magnitude corresponds to the projections for pension funds in the EU Member States, where they grow largest. However, the implied drastic increase in contribution rates probably means that this scenario will not be the reform option to be implemented, though it transmits an important message: *people should understand what they need to pay into a public pension system if they want to preserve current benefit levels and retirement age, and if they want to be fair to future generations.* If they are not prepared to pay this price, then they should – individually and collectively – accept pension reforms that involve reducing the replacement rate and/or increasing the retirement age.

The next step in paving the way for pension reforms is to show results for some illustrative combinations of a decrease in the replacement rate and retirement age increase. In doing this, some thought should be given to the necessity to provide incentives for later retirement in terms of acquiring more pension rights during the additional years at work. Under certain reasonable assumptions, we can show, for example, that a retirement age increase of about three years is required to moderate to a significant degree the rise in contribution rates in the long run. The resulting partial funding is, however, not much different from the base case above, as the induced reduction of pension expenditure and increased contribution revenue in the short run should not immediately lead to lower

contribution rates. Rather, the induced surplus should be saved and put into a fund to cover future expenditure.

This leads to the result that a vast range of pension reform options for a stylised EU-15 economy imply pension fund accumulation of 100-150% of GDP in the next 60 years, of which 2/3 in 30 years. Only if replacement rates were radically reduced would the need for partial funding be removed.

Once the case for partial funding is established, the question of management of the accumulating funds arises, except where the government initially has a large debt and uses the accumulating funds for debt amortisation. In other cases, special institutions could be established to place these funds. Depending on attitudes towards the role of the state, partial privatisation by diverting part of contribution payments to a second pillar might become attractive.

Transition to a notional defined contribution system for reducing the benefit level and providing incentives for later retirement

Transition to a notional defined contribution system is an alternative way to achieve financial sustainability and intergenerational fairness in the public pension system. A basic NDC system encompasses fixed contribution payments recorded in personal accounts which earn an administratively set interest equal to the rate of growth of contributions (*i.e.* wage bill growth if the coverage remains constant). Under such a system, ageing leads to an automatic reduction in the replacement rate, so that pension expenditure adjusts to contribution revenue. As an example shown in the paper referred to above, the replacement rate is ultimately reduced from 60% to 36% for a person who retires at the age of 60.

During the transition from a DB to an NDC system, pension expenditure may exceed revenue. This may lead to an unsustainable path with debt accumulation, while an increase in retirement age strengthens the financial position of the system, as contributions temporarily exceed pension expenditure. Thus, there are many important problems to be settled in designing an NDC reform. Generally, some additional adjustment mechanism is always needed to guarantee the financial sustainability of an NDC system.

As in an NDC system, the projected ageing leads to a considerable reduction in the replacement rate, people may want to postpone retirement in order to earn a higher pension. In addition, the introduction of an additional pension contribution to be paid to a newly established fully funded second pillar (or to a voluntary third pillar) may become an interesting option, and would lead to partial funding of the pension system as a whole.

Depending on choices made, the two alternative reform blueprints, a pre-funded, partially privatised DB system and a transition to NDC, may lead to roughly similar outcomes in many respects, although they differ drastically with respect to rules for determining contributions and benefits, and also require quite different measures for managing the transition. They also cope in different ways with any further changes in demographic factors or in retirement age.

Pension reform scenarios have important implications for public finance target setting. The envisaged surplus in the public pension system should be fully reflected in the general government surplus, as otherwise the purpose of transferring resources to the future would not be fulfilled. Again, I refer to the paper above for further details.

More funding or not

Let me finish by discussing, in the context of the approach presented here, a theme that Nicholas Barr forcefully puts forward. It is the question about the importance of the level of production in the economy. Yes, of course production is important, and the primary source of material wealth. However, we should be rigorous as to which factors affecting the total material wealth are relevant and which are irrelevant in designing pension reforms.

To start with, if something can be done to increase the efficiency in the economy, *i.e.* more wealth could be produced with the same effort, it should be done regardless of ageing and pension reforms. If this is possible, it should not be an argument for being more relaxed towards the problems caused by ageing population. A simple example shows this: assume that pensions are indexed to wages: then any increase in productivity, reflected in wages, is shared between the working age population and the retirees; thus, under a pure PAYG system, the contribution rates do not depend on productivity, but only on the changing structure of population and on the pension system parameters.

The main relevant link between production and the pension system is the retirement age. If and when the effective retirement age increases, and more labour produces more output, the burden of pensions is reduced in every sense of the word, including the lower contribution rates, which are sufficient to support a given replacement rate. This opens the door for an extensive area of research, policy advice and choice to be made by people collectively and individually.

Secondly, it is worth it to discuss the issue whether the difference between PAYG and funding is of second order or not. As I said in the beginning, I agree with Nicholas Barr that some arguments for funding are false or inaccurate. For example, the distortion to the labour market can be alleviated also under a PAYG by strengthening the link between the contributions of an individual and her/his benefit as is done in transition to an NDC system.

However, we should not overlook the importance of moving to partial funding under ageing as a means to implement fairness across generations. It is, in fact, one of the three means available to do it. The other two are a reduction in the replacement rate (which can be done in many different ways depending on the rules of the system), and an increase in retirement age. Combining these three factors (or rather, various parameters behind these factors) we may come to many different results. Partial funding is generally required, except in extreme cases where the replacement rate is drastically reduced and/or the retirement age is significantly increased.

If people do not accept significant cuts in their future pension rights, then they should accept to pay in more. This way, the true cost of their pensions becomes tangible. This is useful for formulating public policy in this area where so much confusing discussion takes place. For this reason, transition to partial funding is useful even in the extreme case where the pension fund to be created would not increase total saving in the economy, as people may correspondingly reduce their private saving. Note that this would be an extreme case, and under normal assumptions pension funding increases total saving in the economy (although less than one to one). This has a positive effect on the capital stock, production and total income.

In conclusion, the case for partial funding is most convincing. It is based on three factors: 1) an ageing population, which is a fact and not only a uncertain forecast, 2) the perception that people want to maintain a pension system which provides significant benefits, even though reduced from current levels, and 3) that people are prepared to take responsibility and not leave an unfair burden to future generations.

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Chapter 8

PENSION REFORM IN LATVIA: ACHIEVEMENTS AND CHALLENGES

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Introduction

Over recent years, three main trends in pension policy have emerged in many countries throughout the world: the transition from unfunded pay-as-you-go (PAYG) pension schemes to partially or fully funded pension schemes; the transition from defined benefit to defined contribution pension schemes, and the transition from state to private management of pension schemes. After regaining independence, the Republic of Latvia started a comprehensive reform, following all three of these approaches. In 1995, Latvia became the first CEE country to start the reform of the old PAYG pension system, and the first in the world to implement the notional defined contribution pension scheme (NDC PAYG).[1]

Latvian pension reform has now been completed. Latvia has six years of NDC PAYG experience (first pillar). The mandatory state fully advance-funded pension scheme (second pillar) was launched in July 2001, and private pension funds (the third pillar) have been operating since July 1998.

The need for reform

Looking back at the former Soviet Union, the social security system was financed from the general revenues of the state budget. In terms of social security expenditure, an unfavourable demographic burden in Latvia, as well as in other ageing parts of the former Soviet Union, was evened out to some degree by nations within the Soviet Union with a very favourable age structure. Therefore, taking a short-term perspective, in a situation of full employment and redistributive income policy, it was possible to retain a low pension age (55 for women and 60 for men),[2] guaranteeing a decent pension level for everyone.

After regaining independence, such a generous and financially unsustainable system, which obviously discouraged work and the payment of taxes, would have inevitably led to a financial crisis.

1. In 1994, the Swedish parliament passed legislation about the design of the Swedish NDC PAYG public pension system, but the introduction of such a system did not occur until 1999; Italy passed similar legislation in 1995 and Poland followed with legislation in 1998.

2. Because of special rights for many categories of pensioners, in practice, the average pension age was considerably lower.

In order to solve this problem, Latvia decided to move towards a radical shift in pension provision. The main goal of the resulting pension reform was to reverse the upward trend in pension expenditure, and to create a sustainable multi-pillar system that corresponded to market principles and was affordable for coming generations.

NDC PAYG pension scheme

The first pillar pension scheme implemented in Latvia in January 1996 differed considerably from the PAYG pension schemes operating in most other countries. Retaining the principle of intergenerational solidarity, the mandatory state non-funded pension scheme mimics a defined contribution scheme. Social insurance contributions, earmarked for public old-age pensions (20% of wages) are recorded in (notional) individual accounts, introduced in 1996, that are given a rate of return until retirement and accumulate (notional) pension capital, while the actual contributions are used for financing current pension expenditure. At retirement, pensions are calculated by dividing the amount accumulated in the notional account by projected life expectancy at the date of retirement, with no gender differentiation.

Box 8.1. **Calculation of annual pension, NDC scheme**

$$P = \frac{K}{G}$$

P: annual pension under the NDC pension scheme;

K: accumulated life-time notional pension capital of the insured person, which is built up from the information in the individual account on the total amount contributed and the annual increase of capital;

G: annuity time period (in years), based on projected unisex life expectancy.

It is possible to receive a pension while continuing work after retirement. Working pensioners continue to contribute and accumulate additional notional pension capital. This newly accrued pension capital also yields a rate of return, and the benefit is recalculated upon final retirement to include this new capital.

It is psychologically difficult for a society, which still faces a problem of relatively high unemployment, to accept an increase in the pension age, although, under the reform, Latvia is moving towards an equal retirement age both for women and men, and at a higher age level. The politically acceptable compromise for the people of Latvia was a gradual increase of the statutory minimum retirement age until it reaches 62 years. A higher limit for the minimum retirement age (for instance 65) was considered to be too far-reaching while the economic and demographic situation is still in the process of improving. The transition to the retirement age of 62 is to be carried out on a step-by-step basis, *i.e.* by six months each year.[3] Men will reach this retirement age in the year 2003 and women in 2008. Up to mid-2005, the legislation provides for the possibility of retiring two years before the age of 62 for men and two years before whatever the retirement age for women then is. Early retirement will be eliminated after this date.

3. The statutory minimum retirement age at the end of 2002 will be 61.5 for men and 59 for women.

As state social insurance contributions are exempt from taxes, old-age pensions are treated as taxable income, with an income tax rate of 25% on the amount exceeding the non-taxable minimum. Currently, the monthly non-taxable minimum for pensions (EUR 178) is five times higher than the non-taxable minimum for other kinds of taxable income.

The new pension provision is capable of maintaining a level of average benefit, equivalent to or higher than that provided by the old system. However, it is directly dependent on the actual pension age, the number of years worked, as well as the dynamics of contribution wage growth, which determines the rate of return for the NDC pension capital. If a person retires at the age of 60, the replacement rate is not less than 40% of pre-tax earnings for a person with a normal work career. If a person postpones retirement until the age of 65, the replacement rate will be around 60%.

Pensions granted before 1996 were not revised according to the rules of the NDC scheme. Nevertheless, the same rules for indexation are applied to pensions under both the new and old laws, that is, until 2002 pension indexation was based on the consumer price index, and from 2002, the changes both in the consumer price index and the contribution wage base will be taken into account.[4]

There is a guaranteed pension minimum that establishes the lowest benefit that can be granted. Such a guarantee is essential, especially during the transition period to the pure NDC scheme. However, it does not correspond to the financing principles of an NDC PAYG scheme. The guaranteed minimum pension is presently financed within the social insurance budget, but it would be appropriate to finance it with general revenues from the state budget. Up to 2002, the guaranteed level for the old-age pension was the same amount as the state social security benefit (available to persons who have no employment prospects, for example, due to congenital disorders), provided by social security at the place where the recipient lives.[5] This has been kept at the level of EUR 53 since April 1998 (currently 50% of the minimum wage). From January 2002, the guaranteed amount of state old-age pension has been increased according to the length of the individual's insurance record, multiplying the amount of state social security benefit by the factor 1.1, 1.3 or 1.5, corresponding to whether the years of service are less than 20, or 30, or more than 30.

Financial preconditions for the implementation of reform

The main task of pension reform was to provide contribution-related and adequate pensions by giving participants a mixed portfolio, with separate parts of the old-age benefit depending on the development of the economy and the financial market. The goal of the policy was to accomplish this task, together with a gradual reduction in the overall contribution rate for social insurance. In circumstances where other comprehensive economic reforms were being undertaken, such a task was ambitious. This was especially the case because it had to be achieved despite a projected increase in life expectancy (including for those who were already receiving benefits under the old

4. According to the current legislation, until 2011, pensions will be adjusted according to the actual CPI and 25% of the real growth of the contribution wage base. From 2011, the adjustment will reflect a 50% share of the real wage growth, with consideration being given to adjusting for 100%, if affordable, in the future.

5. A socially insured person is entitled to the old-age pension, if their insurance record is not less than 10 years. Social security for those who never manage to build sufficient rights in the public pension scheme is provided through the state-guaranteed social security benefit. These persons can receive the benefit, on condition that they have attained an age which exceeds the statutory minimum retirement age by more than 5 years. This benefit was introduced in 1996.

rules), and despite a fertility slump that may take many years to improve, resulting in an increase in the projected old-age dependency ratio. A prerequisite for the success of the reform process was the availability of financial resources, which could be provided by bringing expenditure into line with revenue in the state pension budget.

At the outset of the reform, the goal of reducing expenditure on the new first pillar pension scheme was greatly assisted by following factors:

- Cutting down to a minimum the redistributive function, by making pensions contribution related.
- Creating an actuarial benefit which reduced the pension amount in the case of early retirement (the life expectancy factor in the NDC pension formula).
- Increasing the *de facto* pension age through an increase in the minimum retirement age set by the law, as well as through the incentives included in the NDC pension formula.
- Adjusting pensions by the consumer price index during the first years of the reform only, instead of full wage indexation, as applied in the old system.
- Requiring actual financial coverage for non-contributory periods (sickness, maternity, etc).

An increase in revenue was expected, due to a decrease in the scale of informal work and increased formal participation in social insurance, sustained by the incentives of the NDC scheme.

Notwithstanding the increasing old-age dependency ratio (Figure 8.1) in the long term, the demographic situation for 1995-2010 is expected to be favourable to the realisation of the goals of the reform. Due to demographic factors, the dependency ratio (pension-age persons per 1 000 working-age persons) is expected to decline from 388 in the first year of the reform (1996) to 305 in 2008, and then gradually to increase. Thus, the current decade offers a good opportunity for reforming the pension system.

Advantages of the NDC PAYG approach

The NDC PAYG scheme provides a new approach to pension policy. It is more transparent than a defined benefit scheme normally is, and is based on pure insurance principles. The new scheme is fairer and more flexible, which makes the reform itself politically and financially easier to achieve.[6]

The main arguments for the introduction of this kind of pension formula were that the NDC PAYG pension scheme does the following in a fair way:

- Motivates people to delay their retirement age.
- Equalises pension age by gender.
- Discourages early retirement.

6. Therefore, notwithstanding the frequent changes in coalition partners, governments (eleven since independence) have not altered the direction of the reform.

– Encourages work after retirement.

– Shifts the risks of increasing longevity and early retirement from future to current contributors, as future retirees, while they are still working.

The NDC system generously rewards payment of contributions and delayed retirement. The longer the contributions are made, and the larger the amount contributed (higher contributions, or more accurately declared contribution wages), the larger the pension capital, and consequently, the pension. Accrued notional pension capital yields a rate of return as long as people continue working and postpone retirement. Everybody is free to choose retirement at any age above the statutory minimum. With actuarial adjustments, pension benefits will be higher or lower but, regardless, will be claimed in accordance with individual preferences. Alongside the growth in the economy and labour force demand, the incentives built into the NDC pension formula may influence the average pension age positively, which in the course of time could substantially exceed the statutory minimum pension age. The use of a life expectancy factor has the advantage, compared with a fixed retirement age, of adjusting costs as longevity increases.

The NDC scheme is financially stable in the long run, regardless of the growth rate of the economy, changes in the population and the dynamics of the average retirement age. The core of its design, which determines its stability, is that:

– Pension capital is directly dependent on contributions.

– The rate of return of notional capital is directly related to the growth of contributions.[7]

– The scheme is in long-term actuarial balance, safeguarded by the actuarial considerations taken into account in pension calculations, and by the compensatory indexation mechanism.

For the implementation of the NDC pension scheme, it was not necessary to increase the social insurance contribution rate. Quite the contrary; because of the advantages described above, the new NDC PAYG pension scheme, in the long-term, costs less in comparison with the previous defined benefit system.[8]

Cost-efficiency under the NDC scheme is also strengthened because subsidies are explicit. In comparison with the old system, where financing was not explicit and many advantages had no actual financial coverage, in the NDC scheme any pension credit for non-contributory periods requires actual contributions, which are recorded on an individual's notional account.[9]

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7. Instead of using the average wage during the whole accumulation period, the notional pension capital is adjusted by the growth of the contribution wage base which, by reflecting not only growth in productivity, also changes with the size of the labour force, thus yielding financial stability.

8. The fiscal impact of the reform was evaluated when the draft law for the first pillar pension scheme was elaborated. Estimates show that for the maintenance of the previous pension system, the necessary contribution rate for pensions alone during the period 1995-2050, would have had to increase from 30% to more than 40%.

9. For time spent in military service, or at home taking care of children (maximum 1.5 years per child), contributions to the pension budget are made by the state budget in the form of transfers. Transfers from other social insurance budgets (unemployment, work injury and disability, sickness and maternity) are paid for non-working persons acquiring rights through these systems.

Summarising all its beneficial factors, the NDC PAYG scheme can be considered to be more cost effective than standard PAYG schemes. It also has fewer distortionary effects on the labour market and is better suited to ensuring pension affordability in the mid and long-term perspectives.

Main challenges of the transition to the pure NDC PAYG pension scheme

The evaluation of the performance of the first pillar, that is the pure NDC scheme, is difficult during its initial years of operation. For a long period, three groups of pensioners will co-exist (Figure 8.2). Persons to whom pensions have been granted according to the old rules, prior to 1996, and who are not covered by the new scheme, and persons to whom pensions are granted according to the transitional rules and who have records both before and after the reform, will continue to draw their pensions for a very long period of time. Only in the 2040s will there be no pensioners left who receive a pension under the previous legislation. This is also approximately when the first retirees will start to receive their pensions under the pure new law, to whom the transitional regulations will not apply (*i.e.* who have started working life after 1996, since when all contributions have been recorded into individual notional accounts). But in terms of sustainability of assessing the public pension scheme, the effect of the NDC scheme will only be appreciated around the 2080s, when the category of pensioners with records both under the old and new legislation will gradually cease, and the mature NDC scheme will cover everyone.

This long transitional period, especially if the scheme is affected by the process of restructuring the economy during this time, could generate a serious challenge to making the pension scheme fair, cost effective and adequate. The transition rules reflect this problem of limited transparency and fairness and, therefore, do not ideally correspond to the NDC PAYG scheme's philosophy.

One of the basic problems of Latvian pension reform, which appeared during the transition period, is the inadequacy of the amount of pension compared with the corresponding insurance period. Since old-age pensions are earnings-related, but the average monthly gross wage in Latvia is comparatively low (EUR 284 in 2001), low wage levels also contribute to low pension payments, which for many people are not sufficient to provide an adequate minimum standard of living. The content of the transitional rules applied in Latvia has considerably worsened this situation. In Latvia, the transitional rules of the new pension law were created with an emphasis on the speedy reduction of under-reporting of earnings and consequent labour market distortions, in an attempt to reinforce incentives for contributing from the very first days of the reform. The acquired rights under the old system for persons who become pensioners in the new system were converted into credited notional initial capital, based on years of service before 1996, and the monthly average contribution wage in 1996-1999. Consequently, a significant number of persons with a long work record receive low pensions. This occurred because the period used for the calculation of initial capital (1996-1999), turned out to be very significant for those who had long service records before the reform, but who, during that period, were unemployed or did not make (or their employers did not make for them) any social insurance contributions. Moreover, the length of the period set out in the transitional rules for the crediting of insurance records before 1996 was too short.

These factors led to big differences in the benefits received by persons retiring soon after the introduction of the new legislation and who had similar work histories before 1996, but different earnings between 1996-1999. As a result, several redistributive changes have been adopted during the transition period, in order to protect the living standards of retired people. These, however, also make the scheme more expensive, less transparent and less encouraging of participation.[10] All these

10. Amendments to the pension law have been introduced several times. The last was at the end of 2001 when, nearing parliamentary elections, several positive changes for persons with low incomes and

guarantees are expected to be financed from the same defined contribution pension scheme, based on notional individual accounts, but this is in conflict with the NDC scheme principles and is a source of additional financial commitment and potential financial instability, in the medium term. Taking into account that the share and importance of the initial capital in the total accumulated pension capital will in the course of time decrease, this problem, which occurred in the transition period, will gradually disappear.

The second challenge for the reform is that, due to the rather high rate of unemployment and employers' demands for younger employees, the incentives to postpone retirement have not yet had the anticipated effect. This prevents the expected creation of a positive surplus in the pension budget and, at the same time, affects the well-being of retirees (Figure 8.3).

Demographically-driven declines/increases in the labour force normally lead to short-term financial disequilibrium in pension schemes. However, in the long term, the NDC scheme is in actuarial balance. Incorporation of wage sum indexation of capital, and of life expectancy in the pension calculation formula, largely avoids financial imbalance in the long term, although the liquidity problems caused by demographic fluctuations and imperfections in the actuarial design of the scheme can still be relevant. This creates a need for partial funding of the contributions of large cohorts to enable future pension expenditures to be met. Thus, it is important to develop the Reserve Fund as an integral part of the NDC scheme. Because of political and financial turbulence in late 1990s, the reserves in the social insurance budget in Latvia are still negative, hence creating an additional tax on the scheme in the mid-term. But this problem will gradually be resolved, because of the more or less favourable age structure of the population at present and the continuing mandatory increase in the retirement age. As was mentioned above, the demographic burden will become worse in around ten years. Consequently, it is important to begin now to consider the design and administration of the Reserve Fund in the public pension scheme, as a prerequisite for long-term financial stability (Figure 8.4).

Both women and men face the same incentives in the labour market, and all non-contributory periods under the NDC scheme, including for maternity and child care, have financial coverage. Therefore, the use of unisex life expectancy for the NDC pension calculation in Latvia, where women live on average 11 years longer then men from birth, and at the age of 60 the remaining life expectancy for women is 6.5 years longer than men's, may raise the issue of gender equality in transition. Because of this redistribution, a part of men's accumulated pension capital is forfeited for the benefit of women. Thus, due to large differences in longevity and decreasing differences in career prospects,[11] women benefit from the pension scheme relatively more than men do. On the other hand,

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long insurance records were introduced. Among them, the most important for pensioners was using the national average contribution wage (1996-1999) for the calculation of initial capital, instead of the individual wage, in cases where the wage in that period was lower than the national average, provided the individual's insurance record is not less then 30 years.

11. While women on average (including younger cohorts) earn about 80% of men's wage, the recent statistics about the newly granted pensions show an adverse trend: women in the last three years retired on average four years earlier than men, although their average service record was one year less than for men. Thus, currently, there is no observable difference in the length of the working life between men and women who are claiming a pension (indeed women work proportionally longer than men). Also, unlike in the average wage, there is no gender gap adverse to women in earnings, where these are calculated from the accumulated pension capital of women retiring during the last three years. In fact, this capital was almost 8% higher than that of men in a similar position. Considering such surprising features in the gender equality situation in Latvia, there should be no great difference in accumulated pension capital by gender in the future, when the retirement age will be equal.

if women are relatively poorer than men, the use of unisex life expectancy in the pension calculation serves to transfer money to the relatively poorer women, who live longer, and compensates, to some extent, for the need for widows' benefits. According to demographic projections, a trend towards the equalisation of life expectancies, which is needed for men and women to profit fully from their own accumulated notional pension capital, is projected in the long term.

A potential risk to the success of the reform is in the institutional capacity and political willingness to understand thoroughly the principles and long-term advantages of the reform. Because of its complexity, this was particularly important in Latvia. The new NDC pension formula contains variables, reflecting changes in the labour force, economy growth and mortality rates. Moreover, to understand the way the NDC operates, people need to have some idea of the principles of insurance, which was uncommon, as most people had grown up under the command economy. The weak understanding of the reform aims can be utilised by interested lobby groups to damage the structure of the NDC scheme, for example, by trying to solve the urgent problems of unemployment and social assistance entirely within the public pension scheme, hence destroying its stability and credibility. Recognising that under the NDC scheme, individuals bear direct responsibility for their choices about participation in and exit from the labour force, it is important to show the consequences of individual behaviour. Unfortunately, such activity was not carried out effectively in Latvia during the first years of reform. In contrast to the Polish approach, almost nothing was spent on the public relations campaign about the pension reform, in order to save money. Efforts were solely focused on creating the necessary institutional and administrative capacity. This resulted in a weak understanding of the reform, and a multitude of amendments to pension legislation. Although there was some information on television as well as in other mass media, it did not attract people's attention sufficiently, and therefore many of them did not understand the consequences for themselves of under-reporting earnings or of non-participation in the contribution payments, especially during 1996-1999, which affected their initial pension capital, in accordance with the transition rules. Even now, many people are engaged in the informal sector of the economy, hence depriving themselves of their rights to state pension insurance. Recently, the public relations campaign covering issues relating to the introduction of the second pillar has also included material about the first pillar.

Performance

Since the implementation of social insurance principles, when social insurance benefits became income-related, the declared contribution wage base has increased significantly: in 1997 – 3%, 1998 – 12%, 1999 – 11.7%, 2000 – 6.8%, 2001 – 8.4%. This is despite the substantial informal economy. In early 1998, it was clear that the reform, combined with improvements in the tax administration, had been successful. Sizeable cash revenues in the social insurance budget were ready to be used for further action, such as a decrease in the social tax rate and the implementation of the state funded pension scheme (second pillar). But the situation took a turn for the worse in the second half of 1998. On the revenue side, this was caused by the economic crisis in Russia, the main trading partner for Latvian enterprises at that time. The unemployment rate rose quickly and revenues began to drop. An increase in expenditure occurred with the elections in the autumn of 1998. The government had come under pressure to spend the accumulated surplus in the social insurance budget. This resulted in a substantial extra benefit increase to pensioners above price indexation, and led to a fiscal deficit in the pension budget.[12] The accumulated reserves were completely consumed, and money had to be borrowed from the state budget. By the end of 2001, the accumulated deficit in the social insurance

12. As a result of political decisions, several deviations from the initial strategy were permitted. Consequently, the pension index for years 1996-1999 exceeded the actual consumer price index during this period by 24.3% for the pensioners who retired in accordance with the old pension law, and by 10.8% for the pensioners retiring according to the new first pillar law.

budget had increased to EUR 132 million (1.6% of GDP). Here it has to be noted that, in spite of all these challenges, payment of benefits has never been delayed.

Revenues are projected to decline until 2003, when the scheduled reduction in the overall social insurance contribution rate stops at 33%.[13] Expenditure is projected to increase when the indexation of pensions by the mixed price/wage index is started (in the autumn of 2002), and because the state funded pension scheme has come into operation. The latter substantially reduces the cash flow in the pension budget by the amount transferred to the second pillar. However, the annual deficit in cash is currently on a downward trend.

When will the system return to a surplus? This depends on many factors, mainly on the growth of the economy, the increase in the actual retirement age and the success in collection of the social insurance contributions. Considering favourable trends in the economy[14] and accommodating, for the time being, demographic trends, the deficit in the social insurance budget will be manageable. Baseline projections (Figure 8.5) show a current account cash flow surplus from the year 2005 and positive reserves from the year 2007.

The destabilisation of the social insurance budget clearly indicates the extent to which the system is cost-sensitive, when deviations from the goals of the reform occur. The urgent task to be undertaken, in order to strengthen the medium and long-term affordability of the state pension system, is the continuation of the gradual increase in the pension age and the phasing-out of early retirement.

The state mandatory funded pension scheme

The second pillar in Latvia came into operation in July 2001. It is a fully funded, mandatory state pension scheme, where a part of the social insurance contributions from the 20% contribution rate for old-age pensions are invested in financial assets.

The savings function is based on the unitization principle, *i.e*. individual contributions, invested according to portfolios chosen by individuals, are marked in units. Units are used for accounting purposes in relation to assets and in transactions. The value of a unit, which is subject to investment performance, is calculated as a ratio between the value of assets and the number of units registered, at the time of calculation.

Coverage in the second pillar is mandatory for persons who were under the age of 30 as at 1 July 2001, when the State Funded Pension Law came into force. Persons who were at that moment in the 30-49 age group could affiliate to the state funded pension scheme on a voluntary basis at any time. Participation conditions are simplified to the maximum extent possible, and synchronised with participation in the first pillar scheme. This means that the second pillar will gradually cover almost everyone covered by the state pension insurance scheme. However, persons who were aged 50 when the law came into force, cannot participate. This scheme is expected to be fully mandatory around 2035, when cohorts of voluntary participants will gradually disappear (Figure 8.6).

Incorporation of the fully advance-funded pillar into the public pension scheme in Latvia can be achieved without an additional increase in the contribution rate. Nevertheless, there is a trade-off between its introduction and, first, the rate at which indexation of NDC benefits can be improved, and,

13. At the start of the reform, the social tax rate was 38%.

14. The Latvian economy recovered swiftly after the Russian crisis. The real GDP growth was 7.6% for 2001 – one of the best economic performances among transition economies in that year.

second, potential decreases in the overall contribution rate. In addition, within the overall social insurance budget, the costs of the pension system will include a tax to pay for the introduction of the funded pillar, which will take several decades to disappear completely.

Figure 8.7 shows that the share of contributions dedicated for savings in the second pillar scheme is scheduled to increase gradually, proportionally reducing the contribution rate for the first pillar. Initially only 2% will be transferred. Over time, the contributions to the second pillar will rise gradually to 10% in 2010, reaching the same proportion for both pillars (10%+10% = 20%). As the financing of the second pillar is part of the public pension scheme, all subsidies for the individual, paid by the state budget or other social insurance budgets (in the cases of child care, military service, unemployment etc.), are attributed proportionally to both schemes.

The State Social Insurance Agency contracts with the asset managers and insurance providers, on behalf of the public sector. Until January 2003, the sole second pillar asset manager will be the State Treasury, which has authorisation to invest assets only in Latvian State securities and term deposits with banks. From January 2003, participants in the state-funded pension scheme will also be able to choose private asset managers, offering a broader range of financial instruments. The scheme's participants have the right to change asset manager during the participation period, but not more than once a year.

Private asset managers (investment companies, licensed for operation in Latvia) must have a separate licence for participation in the second pillar. Regulations concerning private asset management have a number of strict limitations, but, in general, they are to be harmonised with the EU Directive on free capital flow. The main restrictions include:

- Second pillar funds shall be invested exclusively in securities issued by the state, municipalities or international financial institutions; debt securities of commercial entities; stocks of commercial entities and other capital securities; deposits in credit institutions; investment funds and derived agreements (only for currency hedging).

- Investment in real estate, loans and self-investment is not allowed.

- Equity, corporate and municipal debt securities should be listed on the official (or similar) list of a stock exchange registered in a Baltic country or in a member state of the EU or EFTA, provided it is a full member of the International Federation of Stock Exchanges.

- Investment is allowed in Baltic countries, the EU, EFTA and OECD member countries, with investment grade credit rating, and with a 70% currency matching limit and a 10% limit for each non-matching currency.

- The maximum exposure to the class of securities from a single issuer: equity – 5%; investment fund units – 5%; corporate debt securities – 10%; bank deposits – 10%. The limit for total exposure to equity related securities – 30% of the total assets of the investment plan.

- The maximum exposure to single issuer: governments and multinational organisations – 35%; banks – 15%; corporations – 10%; municipalities – 5% of the total assets of the investment plan.

As the second pillar is a public scheme, any participant's capital left after death and prior to retirement shall be remitted to the state pension budget for financing survivor's benefits for the dependent family members (children), in accordance with the first pillar law. In such cases, spouses have no rights to survivor's benefits, either in the first or in the second pillar.

There are two options at retirement − at the participant's choice, the accumulated second pillar pension capital will be:

- Added to the first pillar pension capital (refunding option) for calculation of the total old-age pension, based on the NDC scheme formula, and implying that the capital should be funded (in the NDC reserve fund) obtaining the NDC rate of return, or

- Transferred to a life insurance company, which subsequently will provide a whole life annuity.

Taxation rules for the second pillar pensions correspond to the option chosen at retirement − either the rules for first pillar pensions, or those for life insurance products.

Many countries with mandatory funded systems offer a guaranteed rate of return on assets in accounts, despite the controversy surrounding these guarantees. The current Latvian legislation does not offer any guarantees. No additional guarantees are considered necessary because of the security provided by the restrictive investment rules, the availability of a public fund, administered by the Social Insurance Agency (with asset management contracted out), which also administers the first pillar, the minimum suitability and other requirements for asset managers set by legislation, as well as the rules on information disclosure and strong supervision by the State.[15]

For the inception period of 1.5 years administrative and fund management, costs will be covered by the state. After that, the administrative fee will be capped at 2.5% of contributions, but the fund management fee will have no limits.

Advantages of the mandatory FDC scheme

Along with its aim of protecting people by ensuring more money is saved for retirement, an equally important goal is guaranteeing the security of the public pension provision in the long term, by diversification of demographic, labour force participation and financial risks.

The second pillar scheme can also improve the long-term outlook for the first pillar budget by refunding, *i.e.* by transferring savings to the first pillar. The option of refunding, which is an innovative approach and, up to the present time, only embodied Latvian legislation, may improve the liquidity in the NDC scheme and enable more flexible use of the reserve fund in the first pillar. However, in order to avoid financial problems in the future, there is a need to follow carefully the annual status of the public NDC and FDC pension schemes, with regard to their assets and liabilities matching, to ensure that expenditure is being spent wisely. Administrative costs associated with the

15. The Ministry of Welfare will monitor the funded pension scheme, as it forms part of the public pension system. The Finance and Capital Market Commission commenced its activities in July 2001, consolidating supervisory responsibilities previously performed separately by the Securities Market Commission, the Insurance Supervision Inspectorate and the Latvia Bank. It will undertake the licensing and supervision of private asset managers for the period when contributions are accumulating, for the purpose of the second pillar scheme. It will also undertake the supervision of insurance market activity for the annuities period.

second pillar retirement benefits, where refunding takes place, should be lower in comparison to the life insurance choice, because the first pillar will cover them in full.

Contrary to the NDC scheme provision, the second pillar offers more diversified options at retirement. For instance, life insurance apart from standard life pensions offers products like joint annuities, which in the case of the death of the insured person will be continued as a disbursement of the pension to the surviving spouse; delay in starting payment of a pension (for up to 10 years), with a subsequent increase in the pension amount; various periods during which a different amount of pension can be disbursed, etc. As other options in public old-age pension provision do not provide any survivors benefit for a surviving spouse, a joint annuity purchase could improve the living standards for such persons. In comparison with the advantages offered by life insurance, the option of refunding will guarantee a stable pension adjustment in proportion to price and wage increases.

A further important factor, giving an additional benefit from the implementation of the second pillar, is that the funded public pension scheme by definition promotes economic activity, with investments and the development of financial and capital markets; this could prove very beneficial in encouraging higher domestic savings. This also benefits pensioners, as they will gain from the economic growth in the country through pension indexation in the first pillar due to the price/wage index. This economic activity will also benefit working-age people, whose pension capital is regularly indexed by growth in the contribution wage base.

Challenges in the implementation stage

One of the most important conditions for the introduction of the second pillar is the financial stability of the first pillar. As was mentioned above, in the current situation, the revenue from the first pillar scheme does not completely cover all its liabilities to current pensioners, and there is a deficit in the pension budget. Therefore, the implementation of the second pillar in Latvia has been associated with an increase in that debt. Thus, the main risks to successful implementation of the second pillar are related to the activities of the first pillar and the achievement of its goals. According to projections, this should not be a long-term problem, but if the set of objectives and tasks for the first pillar are not fulfilled (the actual pension age does not increase sufficiently and the collection of contributions does not continue to improve), the implementation of the state funded pension scheme by reducing contributions from the first pillar, may become highly priced, creating an additional and prolonged tax for the system and hence destroying the positive balance which is anticipated by the projections.

It was decided, for political reasons, that the contribution rate for the second pillar would gradually increase to 10% in 2010. However, it is difficult to foresee the development of the financial markets and the second pillar's performance during the decade to come. The reliance on a funded scheme may lead to destabilisation of the public pension system, if the increase in the contribution rate to 10% turns out to be too costly, given the other commitments that have to be covered by the social insurance budget. There is a risk that the goal of achieving equal contributions in both pillars of the public pension system (10%/10%) will not ensure the anticipated diversification of demographic and financial risks for the system, but in fact may weaken the system's sustainability. Therefore, the decision to put such a large share of the FDC scheme under the mandatory public pension system in the future should be reconsidered.

The second pillar is an innovation for people who are not familiar with financial markets. Learning from past experience, suggested by the challenges of the introduction of the first pillar, a far-reaching public information campaign has been embarked on before the launch of this scheme. The results of this campaign in 2001, when all the various types of mass media were extensively involved, exceeded expectations. According to a public opinion survey, before the campaign, around 8% of

respondents were informed about the second pillar; as a result of the campaign, this share increased to 75%. Despite this, however, during the first ten months of operation of the second pillar scheme, there was limited interest shown amongst those who could participate voluntarily, in joining it. Apart from the mandatory participants, only 6% of those who could join the second tier voluntarily have signed up to do so. This is considerably lower than the anticipated response.

Why is support from voluntary participants (people in the age group 30-49) so low?[16] Thanks to the efforts devoted to the PR campaign, this result can not be attributed to a failure by the government to communicate effectively the principles of the reform. One reason could be the impact of the bank crisis in 1995 on the historical memory of the population, as well as on its trust[17] in the country's financial and supervisory institutions. This memory may prevent many people from accepting the ideology of the second pillar. For the older segment of potential voluntary participants, the reason for the lack of activity could be the short anticipated time for the accumulation of pension capital. In addition, the rate of return in the NDC PAYG scheme is currently higher than that provided by the second pillar. Because of the conservative investment portfolio offered by the State Treasury, which currently provides about a 5-6% nominal rate of return, the second pillar in its first stage of operation does not seem very attractive. In comparison, the index for the first pillar notional capital, as was noted before, has been much more promising – with almost constant inflation (2.5%), the average annual growth rate of the contribution wage base in the three years 1999-2001, was around 9%.[18] It is possible that the involvement of private asset management from the 2003 could maximise participation rates.

The funded system offers more choice and creates an opportunity for a person to decide in which pension fund to invest money, and whether and when the funds should be turned into annuities at retirement. Nevertheless, it does not necessarily make a person better off. Choice creates not only benefits, but also imposes error; costs, if one chooses badly, for example, if one lacks the necessary financial expertise. Thus, the most important task to be undertaken, in order to achieve the goals of the second pillar, is the improvement of capital market activities and the education of its participants.

Operational outcomes of the second pillar

By 4 April 2002, the State Treasury had received second pillar contributions worth EUR 9 million. Figure 8.8 shows that assets are placed mainly in state securities (89%), earning about 6% annually. The average interest rate for the deposit portfolio is about 5% annually. Assets in deposits are distributed equally between the three banks − Latvijas Unibanka, Pirma Banka and Parex Banka.

As described above, the implementation of the multi-pillar public pension system does not require an additional increase in the overall contribution rate, although it will keep the total costs of the pension system higher than it would have been without the second pillar, for several decades. Nevertheless, with the launching of the second pillar, additional pressure has been put on the social

16. This group covers about half of social insurance contributors, and earnings, on the whole, are equal or higher than for the group of people who are mandatorily involved.

17. Although it is noteworthy that, in this respect, Latvia's regulatory environment is considered one of the tightest in Eastern Europe and the health of the banking system, which is over 70% foreign owned, has improved significantly.

18. Such a situation is not expected to continue in the long term. Because of the stabilisation of the economy and the development of financial and capital markets, the values of both indices should become closer.

insurance budget by the resulting reduction of the resources put into the first pillar pension budget, hence prolonging its overall deficit. The deficit will continue until 2007, according to present projections, after which a steady surplus in the overall budget is anticipated. Under the framework of the scheduled gradual increase of the second pillar contribution rate, the increase in the amount of contributions is directly dependent on wage growth and an increase in the number of participants (Figure 8.9).

While currently the second pillar assets correspond to only 0.1% of GDP, by 2035, estimates show the reserves increasing to about 20-40% of GDP.

Private pension funds

The legislation and supervisory infrastructure needed to implement private pension insurance (the third pillar) were introduced in 1997, making it possible for private pension funds to begin operation from July 1998. There are two types of private pension funds (PPF) − open funds, which can offer services to everyone, and closed funds, whose only members may be the employees of a pension fund's founders. There are no restrictions regarding the founders of a closed PPF. The founders of an open PPF may only be commercial banks and life insurance companies registered in Latvia.

Only commercial banks, life insurance companies, brokerage companies or investment companies licensed by the Finance and Capital Market Commission are allowed to manage pension fund assets.

There are several quantitative restrictions applied to the investments of pension plans:

- Investments in securities of one issuer may not exceed 10% of the total value to the assets of the pension fund, and 25% of the total assets of the issuer of such securities (except government or municipality securities, where investments are not restricted).

- Investments in a single parcel of real estate are not allowed to exceed 15% of the value of the pension fund assets, and the total of all investments, made by a pension fund in real estate, must not exceed 25% of the aggregate value of a pension fund's assets.

- Investments in foreign countries (in securities, real estate, etc.) must not exceed 15% of the total value of the pension fund assets.

The benefits are taxed at normal rates, but the existing taxation policy provides a favourable tax regime for contributions made to a PPF:

- Contributions to the PPF, made on behalf of their employees by a company, are deductible from taxable profits.

- Contributions made to a PPF, which do not exceed 10% of the annual taxable income of the employee concerned, are deductible from income.

- If the total amount of an employer's contributions to PPF, as well as insurance premium payments for an employee's life, health and accident insurance, together do not exceed 10% of the gross wage of the insured person, this expenditure is not subject to mandatory social insurance contributions.

The minimum age at which a PPF benefit may be claimed is 55 years. Payment of the accumulated assets prior to the retirement age may be allowed, however, if a pension plan member is qualified as a Group I disabled person for lifetime, or if the employer contributing on behalf of a pension plan member has declared itself bankrupt, or if a pension plan member dies prior to the retirement age prescribed by the pension plan,[19] or if the member is entitled to terminate membership with one pension plan in order to transfer the pension capital to another plan or fund.

There are three options for PPF pension benefits. The accumulated pension capital can be:

- Paid as a lump sum, or
- Transferred to a life insurance company, which subsequently provides a whole of life annuity, or
- Transferred to the state pension budget (*i.e.* added to the first pillar pension capital) for calculation of a total pension, based on the NDC scheme's formula under the same principles as the refunding option in the second pillar.

Private pension funds in Latvia are defined as non-profit finance and credit stock companies. They are defined contribution oriented, with no guarantees. Members of pension plans, without any additional conditions, have the right to the total amount of the pension capital accrued in the individual account. Restrictive investment rules, special financial requirements (such as a required amount of owner's capital) set for the asset managers, as well as strong supervision by the Finance and Capital Market Commission, constitute a guarantee for the member.

Operational outcomes of the third pillar

The third pillar pension scheme provides the opportunity to accrue private savings for retirement, as well as to develop occupational pension schemes. In addition, the PPFs may be a source of substantial domestic investment, which should encourage more activity in the financial and capital markets. However, the input of the third pillar to the economy in Latvia has been very small during its first years. This may be linked to a relatively low level of income in Latvia, and the fact that people are more inclined, at present, to spend money rather than to save for the future. As the third pillar provides additional retirement savings, mainly for middle and upper income households, there is no majority support from citizens, whose income level is insufficient for private savings. Moreover, the advertising campaigns of small private pension funds cannot achieve the reach of the campaign for the public pension scheme. This has resulted in little interest being shown in participating. Therefore, private pension funds during the first years of their operation showed comparatively low activity, although currently their activity is improving considerably and the number of participants is gradually growing.

By the end of February 2002, the number of participants in the PPFs reached around 18 000, or just 2% of those who participate in the state social insurance scheme (Figure 8.10).

Even with tax relief and other advantages, occupational pension schemes are not popular among small and medium enterprises. There exists just one closed pension fund − Pirmais slegtais pensiju fonds − which serves employees from the two largest enterprises in Latvia (Lattelecom and the State electric energy enterprise Latvenergo), and three open funds (Baltikums, Parex and Unipensija)

19. Rights to additional pension assets, accrued at the day of demise, will pass to the member's legatees.

currently in operation, offering in total eight pension plans. By the end of 2001, the total accrued capital of all PPFs together had reached EUR 17 million (about 0.2% of GDP) (Figure 8.11).

The investment portfolio of the pension funds is rather conservative − 92% of assets have been invested in government securities and deposits (Figure 8.12). Nevertheless, the amount of assets placed in shares has increased by almost 6 times during 2001, and the percentage of shares in the assets composition of the funds has increased from 1.3% to 4.4%. As mentioned above, 15% of the total assets of pension plans can be placed abroad. By the end of 2001, 4% of assets were located in OECD member countries and 3% in Estonia and Lithuania.

While PPFs in Latvia have been operating for a very short time, a significant part of the accrued capital belongs to participants who are 41-55 years old. The level of the average contribution by pension plan participants and employers per month (EUR 22) is low in comparison with the average gross wage in Latvia (EUR 284). Also, statistics show that the duration of participation in a pension fund for the majority of PPF members is no longer than two years. This category owns 99% of the total accrued capital of pension funds. Therefore, the average accrued pension capital per participant is just EUR 973.

Conclusion

Pension reform in Latvia has been completed. The creation of the new, defined contribution public pension scheme in 1996, based on notional accounts, was a major achievement of the comprehensive social security reform in Latvia. As a result, Latvia has become the country with the longest experience in the world of the operation of the NDC PAYG scheme, which is one of the most cost-efficient types of PAYG. Latvia can serve as a model of this type of scheme, providing an opportunity for other countries to learn from its achievements as well as its failures, as experienced in the reform process.

Every indicator of policy analysis shows the theoretical advantages of this new kind of public pension scheme. Compared to the old system, the NDC PAYG scheme is more affordable, equitable and transparent. Creation of the NDC scheme solved an important long-term fiscal problem for the public pension system, because it provided the means to cut future benefits and to increase the future pension age, necessary due to the increasing cost of the system, in a manner broadly perceived as fair. Therefore, it can be considered as the best way of gradually abolishing a redistributive public pension scheme, and of creating one of strictly defined contribution. The implementation of the NDC PAYG scheme also improves incentives to contribute by making benefits dependent on lifetime contributions, thus reducing the labour market distortions associated with the informal economy.

The implementation of the fully advance-funded schemes (the second and third pillars) allows, to some degree, for more optimal risk diversification and faster economic growth, due to more efficient capital allocation, and higher savings and investment. Taking into consideration its impact on the economic, financial and social spheres, the multi-pillar system, of the type undertaken in Latvia, provides in general reasonable stability in relation to possible fluctuations affecting the demographic and economic situation, as well as changes due to political decisions. Still, the full impact of the reform will be only being realized far in the future.

The lessons of Latvia's experience are quite clear and applicable

The idea of a NDC PAYG scheme can be much more easily implemented in developed countries (*e.g.* Sweden)[20] with high living standards and high personal incomes, as these directly affect the level of defined contribution retirement benefits. As the NDC scheme is non-redistributive and therefore less oriented to social cohesion in countries like Latvia, where there is also a developing economy, the shift to such a public pension scheme is radical, and requires substantial and financially costly improvements in the safety net for people in old age to take place at the same time. This is not always achieved. Economic problems in the first years of reform have put serious obstacles in the way of its speedy success. First of all, the success of the radical shift from state to individual responsibility depends on accurately balanced and socially responsible transitional rules. These must take into account the short-term and long-term impact of the decisions made. Prolonging or easing the effects of the transition is very costly, and can affect the financial viability of the pension system in the long term. On the other hand, the cost of a sudden and complete transition can affect the reform ideals and can even undermine whole reform process.

Transitional challenges can occur also in the implementation stage of the second pillar. This type of mandatory financial account scheme can be very desirable in an advanced economy with mature financial and capital markets, and a sound savings culture (as in Sweden). In a country where the financial and capital markets face many transitional and developmental challenges, and where there is a lack of previous experience of investing in public pension schemes, the implementation of such a mandatory scheme, especially without any guarantees, is more risky. Savings in the public pension scheme, which, because of their mandatory nature are expected to be very sizeable, seem very attractive as an available source of finance for domestic investments. Nevertheless, it should not be forgotten that individual well-being, not economic growth, is the primary objective of the multi-pillar pension system. Therefore, in introducing a fully advance-funded mandatory pension scheme as an integral part of the public pension system, the state has to take full responsibility for making this scheme function well. Together with encouraging the development of the financial and the capital markets on a sound basis, as well as developing the growth of regulatory and administrative capacity, scrupulous monitoring of the first and second pillar schemes must be undertaken by the government.

Notwithstanding the social, administrative, technological and political challenges emerging during the reform process, Latvia is set on the right course by choosing the system described above. Along with the improvements in transparency and the gradual elimination of the problems that occurred during the reform process, the increasing success of the reform is fostering credibility.

20. Although Sweden has also started its NDC PAYG pension scheme with very prudent and long-term transitional rules.

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Table 8.1. Selected economic indicators for Latvia

	1996	2001
Inflation (per cent)	16	2.5
GDP in comparable prices, min EUR	4304.6	5670.9
Real growth of GDP (per cent)	2.8	7.6
Wages in comparable prices, EUR	176	283
Real growth of wages (per cent)	-6.2	4.5
Unemployment rate (per cent)	7.2	7.7
Number of old-age pensioners, '000s*	503.9	504.8
Men	---	154.8
Women	---	350
Old-age pensioners as a percentage of total population (per cent) *	20.1	21.5
Average NDC pension, granted in the respective periods, EUR	64	91
Income replacement ratio of NDC pension, as a percentage of the average wage	39	52
Expenditure on old-age pensions as a percentage of GDP (per cent) *	8.2	8.0
Population over working age per 1000 population of working age (over 15)	388	372
Statutory minimum retirement age		
Men	60	61
Women	56	58.5
Actual average retirement age		
Men	60.4	60.6
Women	55.1	56.7
Amount of minimum guaranteed old-age pension, EUR	45	53

* Old and new laws.
Source: Author for the OECD.

Table 8.2. Indicators of performance (at 4 April 2002)

Second tier assets in total, EUR ('000s)	9 515
Per cent of GDP	0.1
Including:	
Latvian state securities, EUR ('000s)	8 442
Term deposits with the banks, EUR ('000s)	679
Correspondent account, EUR ('000s)	394
Average interest rate (%)	5.4
Number of participants	280 000
Per cent of total number of social insurance contributors	27

Source : Author for the OECD.

Figure 8.1. Dependency ratios, Latvia, 1991-2029

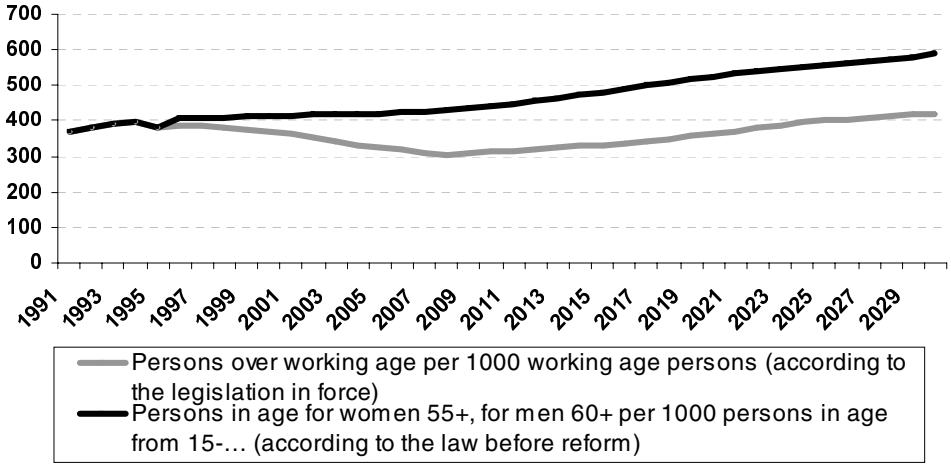


Figure 8.2. Distribution of pensioners by time of retirement

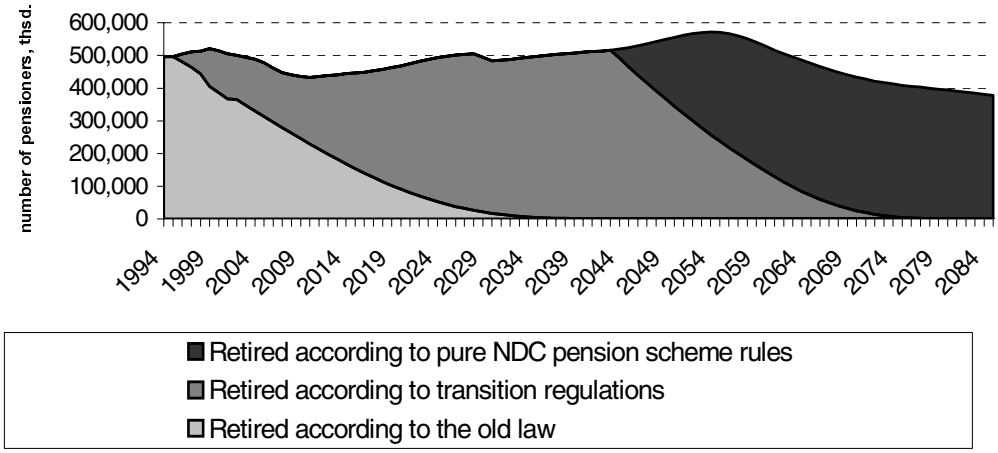


Figure 8.3. Dynamics in the age of retirement

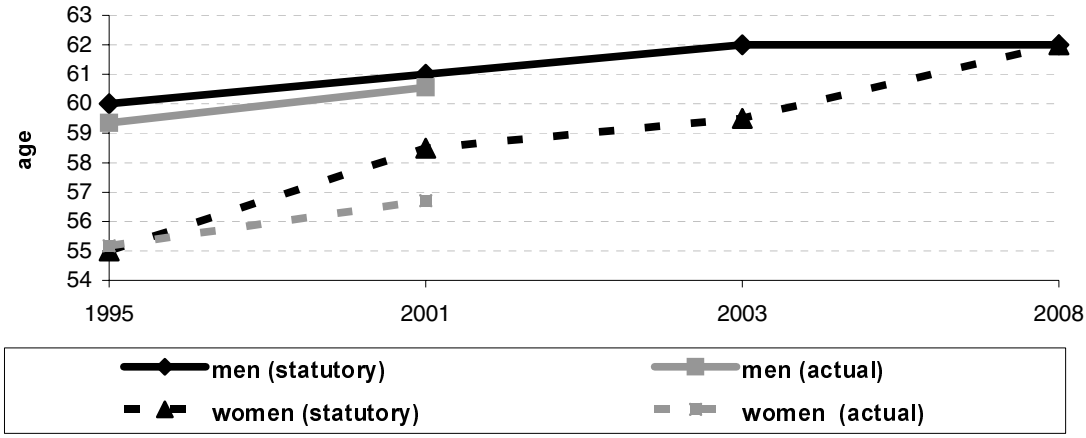


Figure 8.4. Projected life expectancy



Figure 8.5. Accumulated saving/borrowing of Social Insurance Budget in comparable prices, million EUR

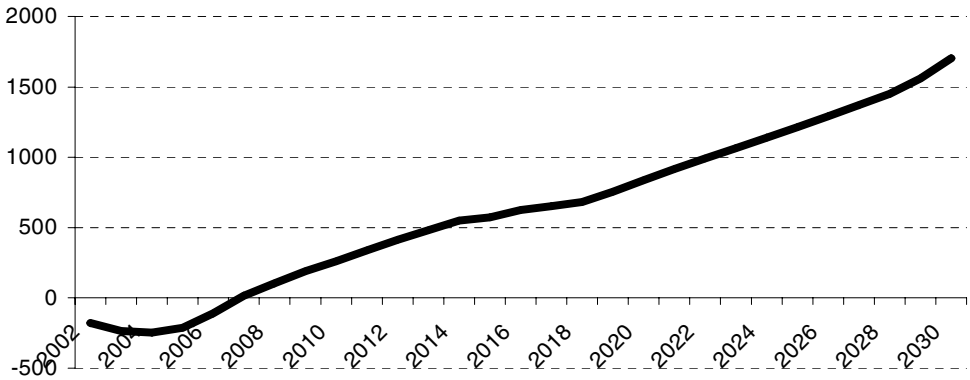


Figure 8.6. Number of social insurance contributors by categories of participation in the state-funded pension scheme

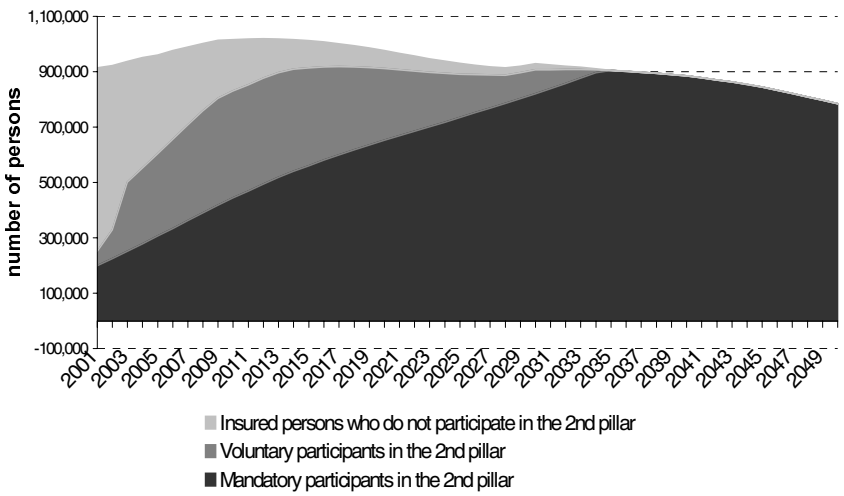


Figure 8.7. Contribution rate to the second pillar

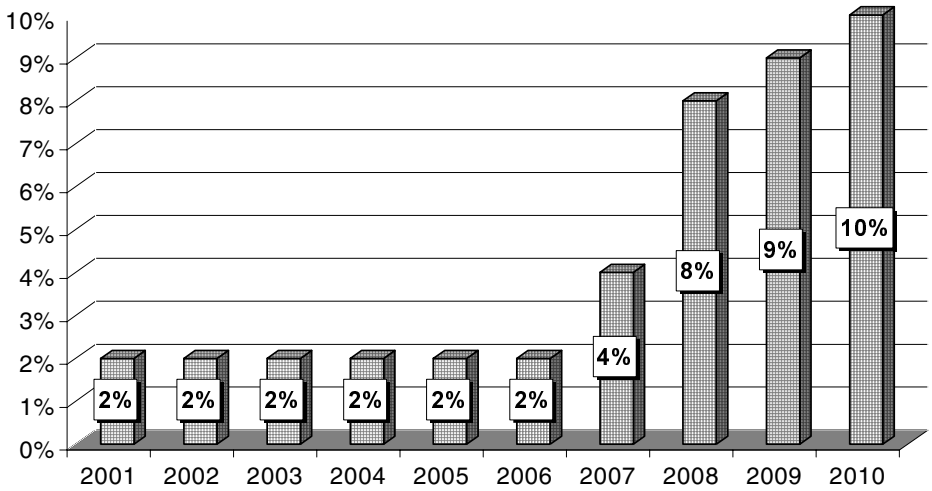


Figure 8.8. Location of second pillar assets 4.04.2002

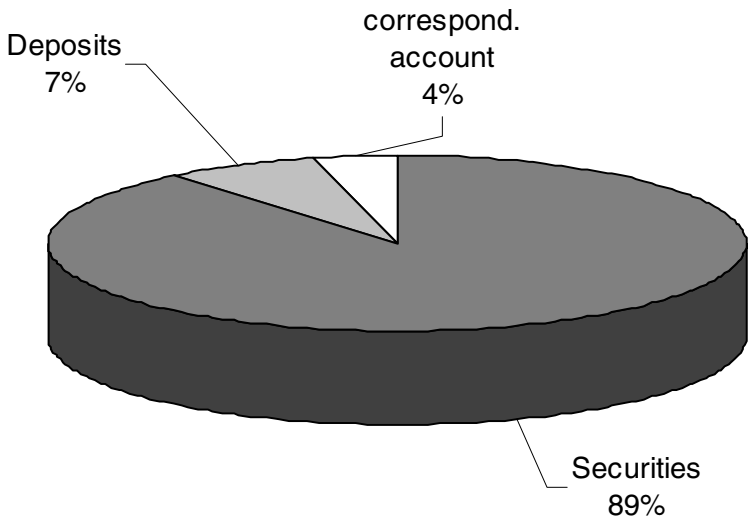


Figure 8.9. Savings in the second pillar, in comparable prices, with 4% annual real rate of return

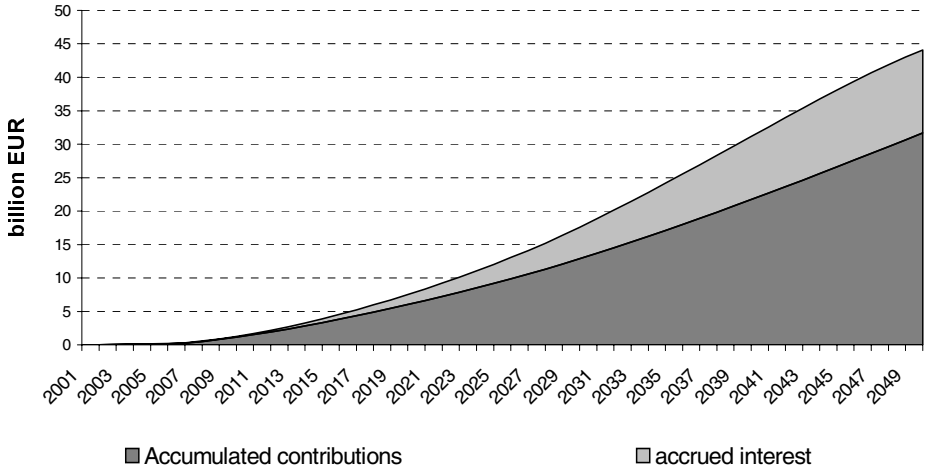


Figure 8.10. Number of participants in pension funds

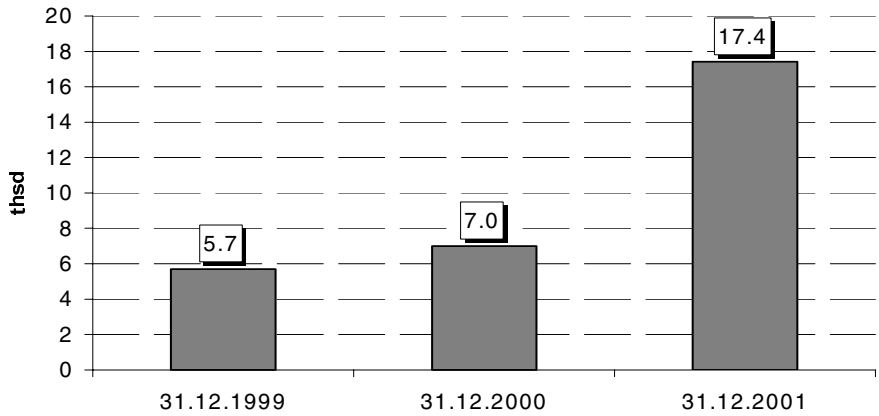


Figure 8.11. Accrued pension capital

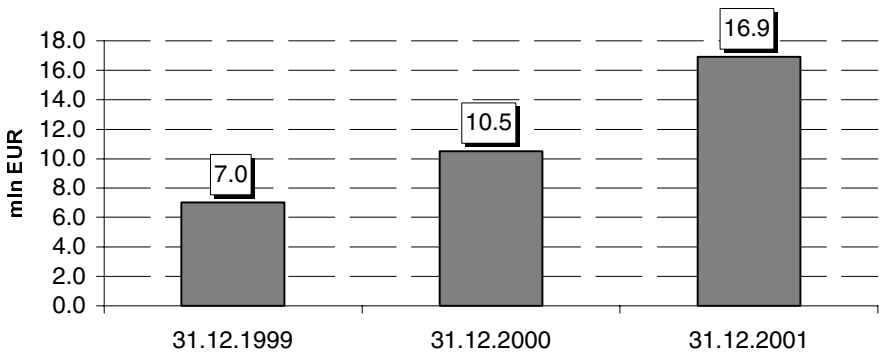
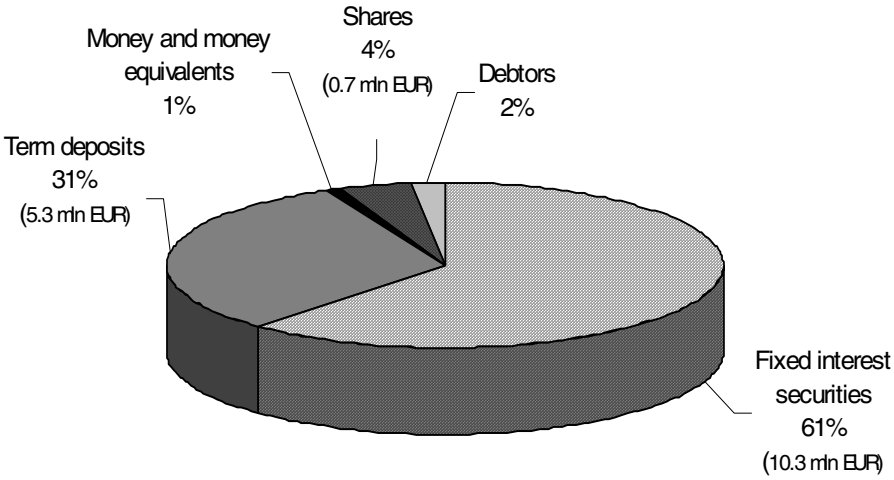


Figure 8.12. Composition of the third pillar total assets, 31.12.2001



Chapter 9

PENSION REFORM IN SLOVENIA

by
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The process of preparing for pension reform took several years in Slovenia (Stanovnik, 2002). The first modifications were made in the early 1990s. Preparation of the comprehensive reform began in 1995; work on the White Paper was very intensive. Expert and political discussions were lively and heated for five years. Both foreign[1] and domestic[2] experts took part in the development of the proposals, and in technical analysis. Even more than the political parties, the social partners (unions, employers' associations and government representatives) expressed their opinions and their disagreements, but eventually agreed upon solutions.

The new Pension and Disability Insurance Act was passed in December 1999, and came into force on 1 January 2000.[3] The model adopted is a combination of:

- A (modernized and modified) Bismarckian pay-as-you-go (PAYG) defined benefit model. Benefits are provided by the Pension and Invalidity Insurance Institute (ZPIZ), which is an autonomous public finance agency. This required the public authorities to prepare, adopt and implement a number of parametric reforms. According to World Bank and European Union classifications, this is the new first pillar regulation.

- Compulsory and voluntary supplementary (pre) funded pension insurance, which can be provided by existing or special new financial intermediaries. The operators (regardless of their ownership) must obtain a licence from the public authorities. This institutional and financial reform introduced (according to World Bank and European Union classifications), the second and third pillars in the Slovenian pension system.

1. European experts under the PHARE Programme and Technical assistance from the World Bank.

2. From academic faculties, research institutes, the Pension Institute (ZPIZ), government representatives and, in some of phases, representatives of the social partners.

3. The Pension and Invalidity Insurance Act was amended three times. No substantial changes were introduced, but only improvements or more detailed provisions. The rationale for and the framework of the system remain the same.

The modernized and modified first pillar

The basic solidarity principles of social insurance retained

In spite of modifications made to the classical Bismarckian PAYG system, the new first pillar retains the basic solidarity[4] principles of social insurance. Insurance remains universal, compulsory and equal for all. Employers through higher contributions finance additional benefits arising from difficult working, conditions in a separate, mandatory pre-funded scheme. Non-discriminatory treatment of insured persons (regarding pensionable age, qualifying period, accrual rates, indexation rules, actuarial adjustments with bonuses) with respect to gender and type of activity, is ensured to a greater extent than in the past (Table 9.1).

To ensure equity for all pensioners (intragenerational vertical redistribution) the upper and lower ceilings for pensions have been re-determined. New benefits not related to earnings have been introduced.

In order to ensure equity for all generations of pensioners, regardless of when they began to receive a pension, a special type of intergenerational solidarity provision was developed. It is shown in efforts to allow new and old pensioners to enjoy − *ceteris paribus* − the same pensions, although the accrual criteria are not the same.

Current and previous pensions, eligibility criteria and other parameters

In its compulsory PAYG financed component, the reform has introduced new rules for the existing types of pension and has introduced new pensions.

The retirement age has been raised; new rules enforce and encourage later retirement; work after meeting the retirement criteria is rewarded; pensions are reduced in cases of early retirement:

- The new law retains the combination of retirement age and pension qualifying period as entrance criteria. The pension reform introduced some elements of flexibility. It is possible to retire between 58 and 63 years of age. Figure 9.1, as an example, illustrates the rules for women's retirement age.

- Some parameters that are applied to the fulfilment of the conditions may also affect the amount of pension. The individual's decision on the age of retirement has clear and predetermined consequences on the level of pension to be received.

Where the insured person remains active

- If the insured person remains active after reaching the age of 63 (men) or 61 (women), the pension is permanently increased above the amount based on the total accumulated accrual rates (for each month of the first year by 0.3%, by 0.2% for each month in the second year, and by 0.1% for each month in the third year). For example: three years of work (until 66 for men or 64 for women), will increase the pension by 7.4%, and the accrual rate will increase by 4.5%. In total, by postponing retirement for three years, the pension will be higher by 12%.

4. Solidarity is a constitutive element of all pension systems organised as a public service. It cannot be treated separately from the notions of equity and redistribution. In terms of social and sociological content, solidarity is related to equity, while in terms of finance, it is related to income redistribution.

– An additional bonus has been introduced if the man has completed 40 years of work (or the woman has completed 38 years) before the legal retirement age, and remains working. The yearly accrual rate in this period is 3% for the 41st year of work, 2.6% for the 42nd year, 2.2% for the 43rd year and 1.8% for the 44th year of work. For women the, same rates apply, but starting from the base of 38 years. Each year of work after this is valued at 1.5%. The total accrual rate after four years of additional work (even before reaching the legal retirement age) would be higher by 3.6% (a 4% to 4.5% increase), in comparison to those working at same age, but not yet having 40 years of work.

If the insured person enters retirement before the full retirement age, the pension reduces by coefficients comparable to those applied for the increase

Reductions in the annual accrual rate

– Each year of the pension qualifying period is worth half a percentage point less (1.5% after 2000 and 2% before 2000 – a 25% reduction in the yearly accrual rate). Previously accumulated accrual rates remain as acquired rights; the consequence is that each year the total accumulated rate for the same qualifying period is different. For an illustration of the combined effect with the rising retirement age, see Figure 9.2.

No upper limit for total accumulated accrual rates if the person continues to work after the full pension qualifying period is reached; elimination of implicit taxation for longer lifetime activity

– The total accumulated accrual rate for the entire insurance period does not have an upper limit. An insured person who continues to work and pay contributions after achieving the full pension qualifying period – 40 years (men) and 38 years (women) – acquires an accrual rate of 1.5% for each additional year.

– If an individual's ability to work is reduced during the economically active period, the new provisions concerning the disability part of the insurance encourage a return to active life.

– Under the new system, family members are insured by means of the family pension (in a similar way to before), while widows and widowers also have the right to receive a widow(er)'s pension.

– A completely new entitlement introduced by the reform is the State Pension, which will gradually be granted to citizens of the Republic of Slovenia aged over 65 with no other income or wealth.

– A more detailed presentation of differences between the current (new − after 1 January 2000) and the previous (old − before 1 January 2000) eligibility criteria, and other parameters is given in Annex 9A.

The first pension or first pillar

According to the World Bank classification, this is the first pillar of the pension system. In the Slovenian case, it would be more appropriate to name the pension from this part of the pension system as the first pension.

What has changed in the first pillar after the new law – fine tuning the new system

The effective creation of a new pension system demands accurate and prompt adjustment to the problems thrown up in its initial operation. This has been the case in Slovenia in the post-reform period. The law has been substantially changed twice.

- Pension adjustments in Slovenia are related to wage growth. This principle was politically controversial. The relevant provision was changed for the year 2001, and again for the year 2002. For the time being, the annual pension adjustment is a wage-price combination. The upper level is the growth of wages, and the lower limit is the growth in consumer prices.

- Active insured persons with atypical employment or income status do not have the same contribution base as is prescribed for employees. This causes many problems in relation to the tax treatment of their contributions and the calculation of their obligation to pay. The amendments have specifically addressed these issues.

- Some questions arising from the new concept of disability were also addressed by amendments, and the law was improved.

- Some technically very difficult provisions relating to implementation were completely rewritten, or their application was postponed for a certain period.

Some of the new instruments (such as the reduction of the yearly adjustment of pensions due to different eligibility criteria for new pensioners), have been submitted to the constitutional court.

Selected indicators after the introduction of the new law

The actual retirement age has risen by one year and one month for men, and by six months for women, in the two years since the system was reformed. As Figure 9.3 shows, this can be seen as a continuation of previous trends, but it can also be interpreted as a change in the behaviour of new retirees. In 1992, when the statutory retirement age was increased by six months, many of those approaching retirement hurried to do so (and were effectively forced to do so, as a result of the labour market situation). In that year, the average retirement age actually decreased by six months, mainly because of the number of women retiring.

As shown in Figure 9.4, the replacement rate fell in 2000 and 2001, as a result of the new valorisation formula, and due to the reduction in the total accumulated accrual rate for the full qualifying pension period. For the next few years, some new changes are expected, so that the replacement rate will perhaps not reduce as much.

The state (national) pension is a new kind of pension, introduced into the reformed pension system after 1999. It was estimated that approximately 18 000 beneficiaries would receive this provision after five years. Currently, there are 11 665 state pensioners in the first three-month period of this year, which is much more than had been estimated for this period.

The contribution rates remained the same in the period after the new law came into effect. Lower growth of the contribution base (gross wages) and higher growth of pension expenditure, caused higher (than planned) transfers from the government budget to the Pension Institute. There was a significant transition cost to the new system. Due to the less favourable fiscal situation in general, some revenues from privatisation were used to cover the deficit.

Mandatory and voluntary supplementary funded pension insurance

One of the characteristics of the previous pension regulations was the complete absence of systemically organised supplementary mandatory and voluntary pension insurance. Pensions were provided only by the classical PAYG system. After 1992, voluntary supplementary insurance was allowed, but there was no further regulation of it; at that time there were only 800 participants.

From the beginning of 2000, there have been a number of opportunities for supplementary (mandatory and voluntary) insurance during a person's active working life.

Supplementary insurance can be collectively agreed between employers and their employees. In this case, employers sponsor the premiums and they are taxed in the same way as compulsory social security contributions.

Regulation of the supplementary pension insurance

Slovenia has no special law on supplementary pension insurance: supplementary pensions are regulated by the Pension and Invalidity Insurance Act, which is the same law as covers the PAYG pension insurance. The reasons for this arrangement are political[5] and historical.[6]

Mandatory and voluntary supplementary pension insurance is now a separate part (four chapters) of the Pension and Invalidity Insurance Act. This explains general issues, deals with the transformation of the existing craftsmen's supplementary pension fund, describes the pension insurance operators and introduces the new institutions (Pension Company and Pension Mutual Funds).

The complexity of pre-funded pension insurance requires, simultaneously, an understanding of the regulations concerning the financial system, the social security system, and taxation.[7] In addition to the regulations effected directly by the law, other more detailed special provisions exist in the form of by-laws, instructions, manuals and other such documents.

Operators in the pension supplementary insurance sphere

Both mandatory and voluntary supplementary insurance is provided by financial institutions, which must meet set criteria in order to obtain a licence. The Pension and Invalidity Insurance Law prescribes three types of operators:

Mutual pension funds[8] which can be:

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5. In the nineties, the only politically acceptable way of introducing the new forms of pension insurance was to treat them within the framework of the current pension system. This was perceived as a way of ensuring the non-speculative character of the new supplementary pension provisions.

6. Historically, the laws in Slovenia tend to be comprehensive and very detailed. Many technically important topics are included in the law, so as to preserve the executive's power to change the essence of the law, by new laws, or decrees.

7. The main laws are: Law on Insurance Activities (2000), Law on Investment Funds and Management Companies, Regulation on Securities, Banking Law and Law on Taxation.

8. A mutual pension fund: 1) represents property financed by the funds collected by paying in voluntary supplementary insurance premiums or resulting from the management of these funds; 2) is owned by the persons insured under voluntary supplementary insurance; 3) is not a legal entity, and 4) is formed

– Open (operated by a bank or insurance company); or

– Closed. A closed fund must have at least 1 000 members from one or from a pool of organisations, or can be established directly by the state.

A pension company.[9]

– An insurance company.

By March 2002, all three types of operators had started operating as supplementary pension insurance providers.

Mandatory supplementary pension insurance

In cases of heavy and hazardous work, the law prescribes mandatory supplementary insurance paid for by the employer.[10] Certain elements of these types of insurance are similar to the second pillar under the World Bank classification.

Mandatory supplementary pension insurance is operated by the Fund of mandatory supplementary pension insurance (Fund), which is managed by the "Capital Company". This is a joint stock company, established by law and state-owned, with the primary task being to manage its assets issued from the privatisation process.

Members of the Fund are the actively insured persons working in jobs with credited periods of insurance (14 months to 16 months of pension period for 12 months of work). An additional criterion is that the pension period is less than 25 years (men) or 23 years (women). By the end of the 2001, 511 employers (sponsors) with 23 061 employees (members of the Fund) had joined the Fund. The total money in the Fund at that time was 4 505 534 thousand SIT (nearly 20 million Euro).

Additional pension insurance connected with the privatisation process

Following the First Pension Fund and the Transformation of an Authorised Investment Companies Act, entitlements arising from ownership transformation can be used for pension schemes (the shares of authorised investment companies can be exchanged for pension coupons). The claims of employees in the public sector arising from unpaid wages (employee vouchers were given instead of part of the wages due) have been converted into pension coupons. Within the framework of the Capital Company (the same body as for mandatory supplementary insurance) a separate Fund was created; the assets came from state ownership and from converted privatisation coupons. The supervisory agency for this type of pension operation is the Insurance Supervisory Agency.

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and managed exclusively for the benefit of the persons insured under voluntary supplementary insurance.

9. A pension company: 1) is a legal entity with a registered office in Slovenia, the aim of which is to provide voluntary supplementary insurance services; 2) has a minimum of 15 000 persons insured under the voluntary supplementary insurance; 3) may be organised solely as a joint-stock company; 4) has no other activities but voluntary supplementary insurance services; and 5) may, on a contractual basis, transfer the operations to another legal entity

10. The current level of the compulsory complementary contribution rates is 4.20% to 2.63% of gross wages.

Supervision of supplementary pension insurance

The variety of institutions providing supplementary pension insurance and the variety of the legal bases for their activities, are the reasons for the complex structure of the supervision authorities in the supplementary pension insurance field. For the approval and licensing of pension plans, the supervisory authority is the Ministry of Labour, Family and Social Affairs. The Ministry also supervises the Craftsmen's (Supplementary) Pension Fund.

For mutual pension funds, the supervisory authority is the Securities Market Agency. For the operations of pension companies and insurance companies, the supervisory authority is the Insurance Supervisory Agency; for tax related operations, the supervisory authority is the tax administration. For all supervisors, the supervision of supplementary pension insurance schemes is a new task. Their recent experience shows that the regulation of supervision must be revised in some areas, primarily concerning overlapping tasks.

Tax status of supplementary pension insurance

The taxation rule of conduct for supplementary pension insurance (operations, insured persons and operators) is EET (exempt, exempt, taxed).

- The income tax base of an insured person is reduced by the amount of the premium paid by the person[11] or paid by the employer into the account of the insured person.[12]

- Premiums paid by employers into voluntary supplementary pension insurance schemes are eligible for tax relief in relation to the tax on an employer's profits.[13]

- Social security contributions shall not be paid from the premium.

- The premium is not part of the pension base of the insured person and shall not be deemed to be a salary payment.

The insurer is eligible for tax relief on condition that the pension scheme is entered into a special register kept by the tax authority. The annual amount of supplementary old-age pension is a part of an insured person's base income for the income tax in the corresponding year.

What has changed in the pre-funded pension provision after the implementation of the new law[14] *– fine-tuning of the new system*

As was the case with the mandatory PAYG pension system, so it has been for the pre-funded part of the system; the first year of its operation has demonstrated a number of inconsistencies, which should be rectified.

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11. Not less than SIT 3 683, or not more than 24% of the compulsory contribution, and not more than SIT 36 830.

12. Not more than 24% of the compulsory contribution, and not more than SIT 36 830, or up to the amount of the difference.

13. Not more than 24% of the compulsory contribution, and not more than SIT 36 830 and not more than the amount of the tax base in this year.

14. At the beginning of 2002.

The majority required for approval of the collectively agreed schemes was lowered from 67% to 51% of the employees in a company. Under the new regulations, each active insured person can participate in two schemes. Thus, it is possible to combine collective and individual supplementary insurance. If this is done, eligibility for tax relief is given to the employer. The possibilities for tax evasion by the self-employed, and by those who are both owner of and employee in the same company, have also led to changes.

The main characteristics of voluntary pensions in Slovenia – an outsider's view[15]

The voluntary pension system is mixed; employers and unions both have a role in establishing arrangements, and assets are managed by specific institutions. The system has partial quantitative portfolio limits. There are limits on asset categories, and implicit procedural rules on decisions. The law defines reporting requirements, multiple supervisory authorities have been established, partial limits on expenses have been set, and return guarantees are given.

However, the pension law does not cover some essential elements. The authority over the actions of employers in relation to pension issues is not prescribed; a comprehensive definition of responsible parties is missing, and a regulation containing an explicit framework for standards of conduct should be adopted. Conflicts of interest/self dealing prohibitions are new issues for Slovenia's financial system, as are limitations on indirect expenses, and reference to valuation standards. Some rules on the presentation of rates of return and the crediting of accounts must be standardised, and marketing requirements or limitations have to be imposed.

Some anticipated challenges[16]

In Slovenia, the payment system has completely changed, and there is no public authority that ensures the fulfilment of their obligations by employers, such as payment of contributions. So if the integrity of contribution flows is to be assured, the potential for self-dealing and asset skimming needs to be reduced by regulation. Portfolio restrictions will perhaps cause convergence and low returns. The creation of prudential standards, ensuring consistency of presentation of returns, and countering the potential for manipulation are among the future tasks for regulators. Sanctions are not prescribed for certain unforeseen behaviour, so it will be necessary to establish the scope of the available sanctions, and to co-ordinate multiple supervisory authorities. As soon as possible, standards for annuity purchase should be adopted.

Multi-pillar and multi-pension structure

The current pension picture in Slovenia is completely different from that existing prior to 2000. In contrast to the previous situation with uniform, mandatory pension provision and only one pension-provider, there now is a complex structure of voluntary pension insurance along side the mandatory social insurance structure. This structure can be classified in a number of ways; according to the World Bank classification, it is a first and third pillar, structure with some elements of the second pillar plus some additional elements. However, the European classification is more appropriate to describe the pension picture.

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15. Richard P. Hinz, US Department of Labor, Private Pension Regulation: Principles and Variations; presentation in May 2002 for Slovenian pension regulators.

16. Richard P. Hinz, US Department of Labor, Private Pension Regulation: Principles and Variations; presentation in May 2002 for Slovenian pension regulators.

In any event, diversity in social security is a fact. A currently active insured person could at retirement obtain four types of pension:

1) First pension from ZPIZ (first pillar)

Old-age, invalidity, and survivor's pensions from the social insurance system will be the main sources of income in old age. Their role will be reduced, but not removed. This system constitutes the precondition for other pensions (except the additional pension from privatisation)

2) Second pension from the second pillar

Mandatory supplementary insurance and collectively agreed supplementary insurance paid for by the employer are the bases for the second pension. The present development of supplementary insurance indicates that this will be the prevailing form of supplementary pension provision.

3) Third (or second) pension or third pillar

If the insured persons themselves opt to take out supplementary pension insurance and pay the (supplementary) insurance premium, they benefit from a tax exemption up to a certain level of premium. Under the World Bank classification, this type of insurance is similar to a third pillar pension. In cases where the person is eligible for the second pension, this pension is the third pension.

4) Additional (extra) pension from privatisation

For those who exchanged shares of authorised investment companies for pension coupons or bought them in the capital market, this will represent an extra pension. All together, four types of pension, regulated by two separate laws, coexist in the Slovenian pension system.

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Stanovnik, T. (2002), "The Political Economy of Pension Reform in Slovenia", in E. Fultz (ed.), *Pension Reform in Central and Eastern Europe, Volume 2: Restructuring of Public Pension Schemes: Case Studies of the Czech Republic and Slovenia*, ILO-CEET, Budapest & Geneva.

Table 9.1. Voluntary and mandatory (pre) funded supplementary pension insurance
Situation at 31 December 2001

MUTUAL PENSION FUNDS

Number	Operators	Investment	Members (000s)
6	Voluntary Mutual Pension Funds	1,160, 872	15.9
1	Mandatory Mutual Pension Fund	4,505,534	23.1
7	Mutual Pension Funds	5,666,406	39.0

INSURANCE AND PENSION COMPANIES

Number	Operators	Premiums	Insured persons (000s)
3	Insurance Companies	1,981,797	20.6
6	Pension Companies	3, 306, 543	45.4
9	total	5,288,340	66.0

Source: Security Market Supervisory Agency, Ministry of Labour, Family and Social Affairs; Insurance Supervisory Agency.

Figure 9.1. Rules for women's retirement age

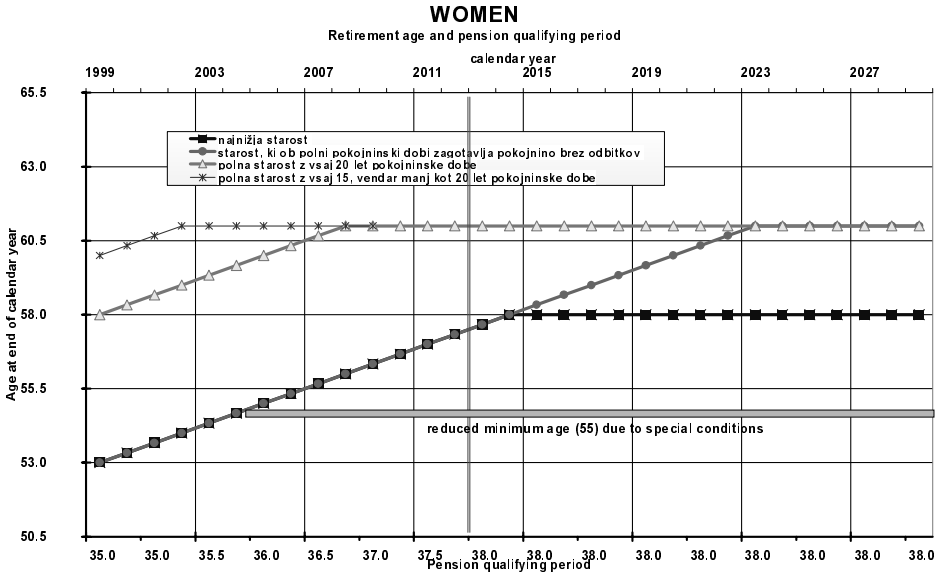


Figure 9.2. Total accumulated accrual rates

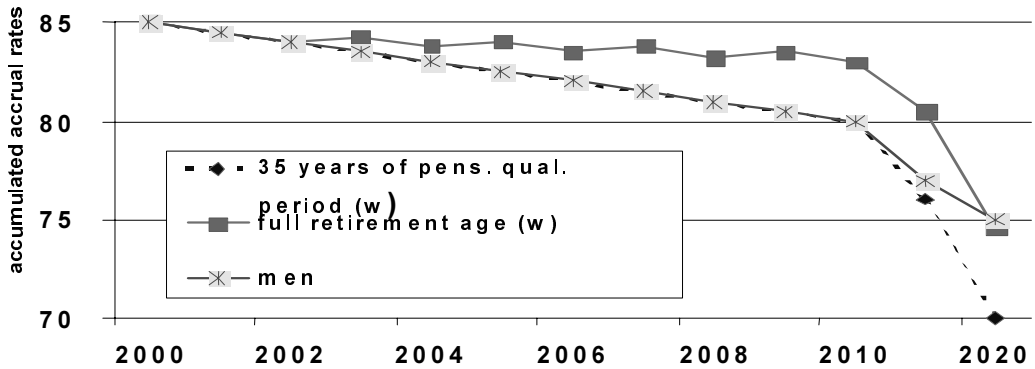
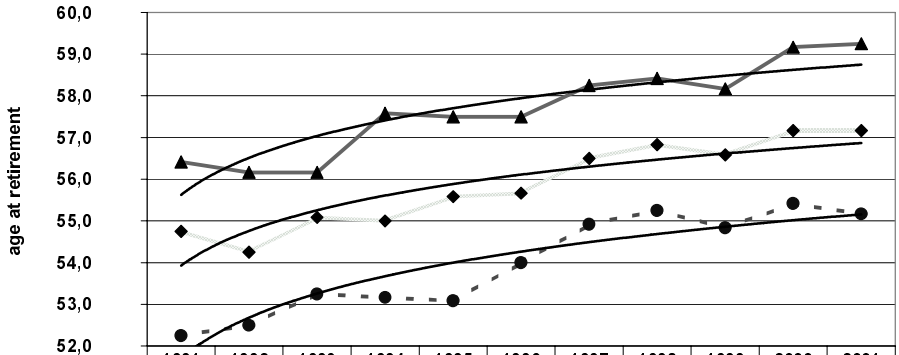
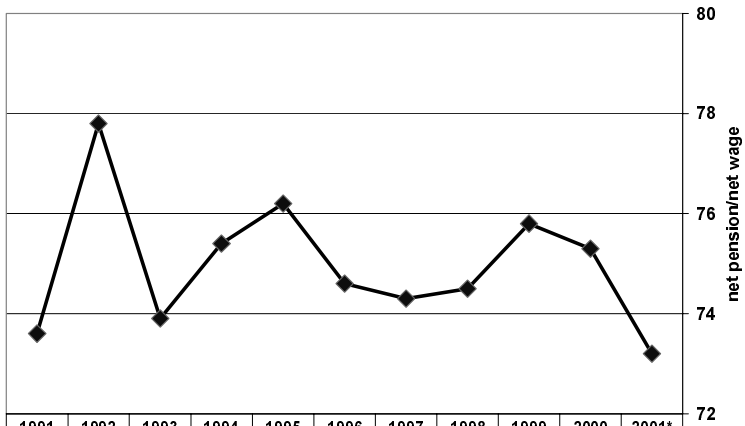


Figure 9.3. Effective average retirement age for old-age pensioners, 1991-2001



	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
men	56,4	56,2	56,2	57,6	57,5	57,5	58,3	58,4	58,2	59,2	59,3
women	52,3	52,5	53,3	53,2	53,1	54,0	54,9	55,3	54,8	55,4	55,2
both gender	54,8	54,3	55,1	55,0	55,6	55,7	56,5	56,8	56,6	57,2	57,2

Figure 9.4. Average replacement rates for old-age pensions, 1991-2001



	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001*
Replacement rate	73,6	77,8	73,9	75,4	76,2	74,6	74,3	74,5	75,8	75,3	73,2

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ANNEX 9A.
PARAMETRIC REFORM
(WHAT IS NEW IN THE PAYG PART OF THE PENSION SYSTEM)

OLD-AGE PENSION

Principal new features	Post-reform arrangements	Arrangements prior to the reform
The retirement age and pension qualifying periods are increased, while the difference in retirement conditions between men and women is reduced.	Retirement under the existing and post-reform arrangements is possible when both the age condition and the pension qualifying period condition are met. Under the post-reform arrangements, three different periods continue to apply to the pension qualifying period, while age is linked to the pension qualifying period as follows:	
	1. 40 years pension qualifying period for men (m) and 38 years for women (w) (full pension qualifying period): • minimum retirement age 58 (m) and (w), • full retirement age 63 (m) and 61 (w).	1. 40 years pension qualifying period for men (m) and 35 years for women (w) (full pension qualifying period): • retirement age 58 and over (m) and 53 and over (w).
	2. At least 20 years pension qualifying period but less than 40 years (m) and 38 years (w): • full retirement age 63 (m) and 61 (w).	2. At least 20 years pension qualifying period but less than 40 years (m) and 35 years (w): • retirement age 63 and over (m) and 58 and over (w).
	3. At least 15 years, but less than 20 years pension qualifying period for men and women: • retirement age 65 and over (m) and 63 and over (w).	3. At least 15 years, but less than 20 years pension qualifying period for men and women: • retirement age 65 and over (m) and 61 and over (w).
Increase and reduction in pension.	If the insured person remains active: • after reaching the age of 63 (men) or 61 (women), the pension is permanently increased above the standard amount based on the total accumulated accrual rates, or where, if man, he has completed 40 years or if a woman, she has completed 38 years of work but the insured person has not reached the ages described above, their pension is still increased as outlined above.	If the insured person remained active after fulfilling the age condition and the pension qualifying period condition, the pension was permanently increased by 1% for every year of work and insurance.

Principal new features	Post-reform arrangements	Arrangements prior to the reform
	The pension is permanently reduced below the amount based on the total accumulated accrual rates even though the pension qualifying period has been completed if the working career prior to the age of 63 (m) or 61 (w) is not 40 years (m) or 38 years (w).	The pension was reduced by 1 for each year (maximum of five years or 5%) of early retirement until the age condition was fulfilled.
Reduction in the annual accrual rate and increase in the total accumulated accrual rate for continuing to work after the full pension qualifying period is reached.	The annual accrual rate (the value of one year's insurance) is reduced from 2% to 1.5%; at the same time the initial accrual rate is increased for the first 15 years of active insurance.	The annual accrual rate (the value of one year's insurance) was 2%; the initial accrual rate for the first 15 years of active insurance was 30% (m and w).
	The total accumulated accrual rate for the entire insurance period does not have an upper limit. An insured person who continues to work and pay contributions after achieving the full pension qualifying period – 40 years (m) and 38 years (w) – acquires an accrual rate of 1.5% for each year.	The total accumulated accrual rate for the entire insurance period had an upper limit of 85%. For an insured person who continued to work and pay contributions after achieving the pension qualifying period – 40 years (m) and 35 years (w) – the total accumulated accrual rate did not increase (it remained at 85%).
Taking into account time spent bringing up and caring for children.	In order to take into account time spent bringing up and caring for children in their early years, the period in which the pension would otherwise be reduced because of not completing the number of working years is shortened.	Bringing up and caring for children in their early years was not a special condition and did not affect the amount of the pension or the fulfilment of age conditions.
Taking into account work done by women before the age of 18.	Work done by women before the age of 18 can reduce the minimum retirement age, but to no younger than 55.	There were no relevant provisions.
Equalisation of the retirement age taking account of the various special conditions laid down by specific laws.	It will not be possible under any regulations to obtain an old-age pension before the age of 55. In the period between the age when they complete the full pension qualifying period and the age of 55, workers with privileged employment status will receive an occupational pension, for which a special pensions scheme will be drawn up.	Special regulations reduced the age condition in certain cases to below 50.

Principal new features	Post-reform arrangements	Arrangements prior to the reform
Reduction in the ratio between the minimum and maximum pensionable base for the full pension qualifying period.	The ratio between the minimum and maximum pensionable base for the full pension qualifying period under the new law is 1:4.	The ratio between the minimum and maximum pensionable salary for the full pension qualifying period before the reform was 1:4.8.
General invalidity	The right to receive a disability pension is acquired on the basis of general invalidity, when the insured person is no longer capable of performing any sort of organised work (the allowance depends primarily on the category of disability).	Entitlements under disability insurance were not broken down in the same manner as in the post-reform arrangements. As a rule they were permanent and were less oriented towards re-entering the workforce or acquiring and making use of a person's remaining capacity to work.
Occupational disability	The right to receive a disability pension is acquired on the basis of occupational disability, if the insured person no longer has any remaining capacity to work as a result of a 50% or greater reduction in their capacity to pursue their occupation.	
Reduced or restricted work capacity	The right to receive a disability pension can also be acquired on the basis of reduced work capacity, if the insured person's work capacity to pursue their occupation is reduced by less than 50%, *i.e.* in the case of restricted work capacity, when an insured person who has reached the age of 63 (men) or 61 (women) is no longer able to work full time but can carry out certain work for at least half of the full time hours.	

WIDOW (ER)'S PENSION (*new entitlement*)

Principal new features	Post-reform arrangements	Arrangements prior to the reform
Age conditions	• The widow(er)'s pension is the benefit received by the surviving spouse of a deceased insured person or pension recipient: if on the death of the spouse the survivor has reached the age of 53, or when the survivor reaches the age of 53 if the survivor was at least 48 years old when the spouse died; if on the death of the spouse the survivor is not an insured person but is at least 48 years old, or when the survivor reaches the age of 48 if the survivor was at least 45 years old when the spouse died.	The surviving spouse of a deceased insured person or pension recipient received a family pension on fulfilment of the age conditions. A widow or widower who, in addition to being entitled to receive a family pension, was also entitled to receive an old-age pension or a disability pension, could choose which pension to receive.
Pension level	The widow(er)'s pension is 70% of the basic family pension. A widow or widower who, in addition to being entitled to a widow(er)'s pension, is also entitled to receive an old-age pension or a disability pension, may choose which pension to receive. If it is more favourable for the widow or widower, they may be paid in addition to their pension, an amount equal to 15% of the widow(er)'s pension, provided that the total payment may amount to no more than 90% of the average pension paid in the country in the previous calendar year.	The rules for the family pension applied: the benefit paid to the surviving spouse depended on a combination of the number of persons entitled to receive the family pension and on age.

STATE PENSION (*new entitlement*)

Principal new features	**Post-reform arrangements**	**Arrangements prior to the reform**
Age and residence conditions	Every permanent resident in the Republic of Slovenia who has reached the age of 65 and who between the ages of 15 and 65 spent at least 30 years living in the Republic of Slovenia receives a state pension.	There was no state pension: the social security system contained a similar benefit (social assistance as the sole (or one-off) means of survival).
Income, conditions and amount	A person receives a state pension: • If they are not entitled to any other type of pension in Slovenia, • If they are not receiving a pension from a foreign public pension system or in accordance with other provisions, • Provided their own income does not exceed the means-tested amount for acquiring the right to receive income support. The state pension amounts to 33.3% of the minimum pensionable salary.	

Chapter 10

FINANCIAL CONSTRAINTS AND POLICY OPTIONS: THE PENSION REFORM PROCESS IN ITALY AND ITS RELEVANCE TO TRANSITION EUROPEAN ECONOMIES

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Introduction

In the 1990s, several West European countries introduced major reforms in their pension systems.[1] In general terms, the main purpose of these reforms was to improve financial sustainability within the context of an ageing population and a decreasing ratio between the active and non-active population. These changes in the demographic structure and in labour markets, as well as their impact on pension systems, had been known for years, indeed for decades, but little or no action had been taken. However, pension reforms were triggered only when the public finance constraint became visible and tangible through the 1992 financial crisis that jeopardised the European Monetary System (EMS) and forced some EMS countries, including Italy, to request a suspension from the European exchange-rate agreements. The financial and economic constraints became even more apparent with the decision to create a common European currency, the euro. This required all participating countries

1. For example, Austria froze benefits in 1996 as a part of the sparpaket (austerity package) and increased retirement age, cut early retirement provisions and reduced benefits for public-sector employees in 1997-2000; Denmark introduced a special levy on higher gross pensions, cut early retirement benefits and increased normal retirement age in 1994-1999; France modified downward benefits in the private sector pension system in 1993, ended favourable early civil-service retirement in 1995 and introduced the basis for a two pillar system through private pension plans in 1997; Germany changed indexing of pensions, phased out early retirement options and increased retirement age for women in 1992, introduced a demographic factor in benefit calculation in 1997, and made further reduction in benefits in 1999; these changes prelude a major pension reform approved in 2000; the Netherlands linked benefits to the ratio between active to non-active population in 1992 and privatised the civil service pension fund in 1995-97; Sweden designed a new pension system in 1998: gradual increase in minimum age for pension entitlement, benefits based on working life earnings; introduction of fully-funded individual accounts. The UK diminished benefits of the state earnings-related pension scheme, introduced private individual pensions and ended special early retirement schemes in 1988/89, and revised solvency standards for pension funds in 1995 (Boeri *et al*., 2001).

to aim at clear-cut, measurable targets, and meet specific deadlines to reduce annual public finance deficits and the stock of public debts, and achieve the same level of interest rates and a viable financial market in the overall euro area.

Pension reforms in Italy are exemplary in that, after a long phase of inconclusive discussion in the 1980s, when the need for major adjustment was already apparent, the process was only started up after the 1992 foreign exchange and public finance crisis; it continued in following years under the pressure of meeting Italy's goal to be one of the founding members of the European Monetary Union (EMU). Thus, albeit the major differences in per-capita income, structure of the economy, role of the government and depth and breadth of the welfare state, the pension reform process has several analogies with the challenges currently faced by transition economies in Central and Eastern Europe. In most of these countries, pay-as-you-go (PAYG) occupational systems prevailed until the late 1980s-early 1990s when they suffered a severe contraction in real output and public finances (Wyplosz, 2000), that is, an external crisis as a trigger and the need for long-term financial stability as the lever to achieve an effective, efficient, sustainable and equitable pension system as a part of a well-functioning social safety net and welfare system. An external crisis is also the lever to develop a safety net for European transition economies as clearly identified already in the mid-1990s (World Bank, 1996). Although focused on the Italian case, the paper includes lessons for the European transition economies now in the process of designing their own pension and welfare systems.

After this introduction, the second section of the paper depicts the general development of the Italian pension system, emphasising the aspects relevant to transition countries and the problems it faced in the late 1980s. The third section summarises the attempts to handle the problems before the 1992 financial crisis. The fourth section focuses on the interaction between the 1992 crisis and the start of the reform process. The 1995-97 pension reforms are outlined in section five. The sixth section charts five models for further change and development. In the seventh section are summarised the lessons to be learned from the Italian experience. In the eight and final section, the focus is more specifically on the relevance of the Italian case to European transition countries.

General features of the Italian pension system and its evolution in the 20th century

In short, in the late 1980s, the Italian pension system was a highly fragmented, occupational pay-as-you-go scheme, financed by payroll taxes and employers' and workers' contributions; it also featured a level of benefits linked, by and large, to earnings in the latest or best years of working life (Ferrera, 1984; 1998). It appeared dramatically out of line with the pension systems of the rest of Europe:

- Albeit, at nearly 25% of GDP, Italian public expenditures on welfare were broadly in harmony with the European average; as much as 60% of these expenditures were channelled to over 100 different public pension schemes and absorbed 13% of GDP (whereas the European Union average placed public pension spending at 40% of welfare expenditure and at some 10% of GDP).

- The ratio of payroll taxes and contributions to wages and salaries was twice as much as that in France and Germany, and four times as much as in the United Kingdom (and greatly impinged on Italian labour costs and competitiveness).

- Transfers from active population to pensioners were estimated at ITL 2 500 trillion, in terms of resources additional to those drawn from payroll taxes and contributions paid by current pensioners when they had been active workers; this caused a socially unacceptable intergenerational inequity.

- OECD and IMF estimates pointed out that, without major reforms, annual public expenditures on pensions would have reached 21% of GDP by 2030 and the public debt on pensions would have peaked at six times GDP by 2050, jeopardising public and private spending on other social and economic activities.

- Econometric studies clearly showed that such an imbalanced pension system had severe static and dynamic implications on the allocation of labour and capital markets; the sluggish level of growth of the Italian economy was caused by this burden.

It is interesting to see how and why the pension system had evolved into such a key issue over a comparatively short period (less than a century), during which Italy, like many Central and Eastern European countries, transformed its economy and society from an agrarian-based structure to a post-industrial, high value-added, service-oriented one. In the Italian experience, each stage of economic growth and transformation had a different pension system; but cumulative errors were made in the changeover between systems, creating severe financial and economic problems in the late 1980s.

The beginning of a compulsory pension system went hand-in-hand with the start of industrialisation in the inter-war period. As the population moved from country and rural areas to towns, and from agriculture to manufacturing, schemes had to be developed to look after the aged because they could no longer rely on the traditional extended family network to support them after their working life. The solution was found in compulsory savings schemes that would provide an income when the worker could no longer be employed. Employers were required to contribute to these compulsory savings because it was thought they should help support the aged after making use of their human capital and skills during their working life. The pension system developed into a fully-funded occupational scheme similar to those evolving around the same period in Germany and France (Flora and Heidenheimer, 1983); alongside this, labour legislation and practices would provide, first *de facto* and later *de jure* (with legal constraints), for life-time employment in the growing Italian manufacturing sector (Pennisi, 1996). The mechanisms were gradually extended to employment outside manufacturing and the civil service, the first sector to borrow the idea and adapt it to its own needs; commerce, banking, self-employed workers and professionals and, naturally, also farming, developed their own fully-funded occupational pension schemes.

Most Central European countries (*e.g.* Poland, Hungary, Romania, the Czech Republic) modelled their pre-World War II pension systems along these lines for two main determinants: a) they were patterned after the German system seen as a model since Bismarck times; b) they fitted the then ongoing transformation from agrarian to industrial societies around a few heavy manufacturing development poles. Some of the basic ideas where borrowed in the Eastern European countries, primarily Russia, where no pension system existed at the time of the socialisation of the means of production. Gradually, in the Central and Eastern European countries, the pension system was extended to cover many transfer payments to households for any kind of income support. A similar, but more limited, development took place in Italy. In Central and Eastern Europe, the development was accentuated by the fact that a single social insurance contribution financed the whole gamut of risk-related benefits (such as unemployment benefits and, to a certain extent, pension benefits) and others (such as family allowances). In addition, as administrative capabilities were very limited and pensions were paid in cash through the extensive and extended network of the post office, ease of payments caused almost all the household transfers to be included under the overall pension umbrella.

In Italy, the pay-as-you-go occupational schemes worked relatively well before World War II; in certain periods, they even provided a surplus to the general budget because of a marked difference between actual and expected financial yields (Coppini, 1994). The Italian fully funded occupational system did not break down because of long-term changes in the population's age profile and in the

labour market. Well before these trends had become apparent, World War II and its aftermath had brought about high inflation, turmoil in financial markets and extremely low yields for occupational pension funds placed in real estate and government bonds. To avoid a dramatic and sudden impoverishment of those already on pensions, the fully-funded scheme was gradually modified to become a mixed system with features of both the fully-funded and the pay-as-you-go schemes. The system was still structured along occupational lines and mostly financed by payroll taxes and employer-employee contributions. However, increasing claims were made on general taxation through special "countervailing funds" to offset part of the implications of the financial and economic consequences of World War II on pensions. In Eastern and Central Europe, instead, the systems were in severe jeopardy; mainly because, as explained above, on pension payments fell the burden of all social insurance transfers and also in that in the late 1980s, the pensionable age in Central and Eastern Europe was five years lower than in Western Europe; large groups, such as miners and teachers, were entitled to retire even earlier. As a comparison, on average, a typical Central and Eastern European enjoyed four to six more years of retirement than his Western counterpart. On the other hand, in Central and Eastern Europe, retirement payments hardly provided for indexing; as a result, in real terms, pensions were drastically curtailed by rampant inflation in the 1990s.

In Italy, the changes haphazardly made to various elements and segments of the system, each occupational category's scramble to obtain a better pension than the others, as well as, finally, the short-sighted view that current payments (payroll taxes and contributions) could always be manipulated to meet the pensions bill, all helped to create a real "pension maze" (Castellino, 1975). The "maze" contained serious inequities between workers of the same generation (but belonging to different occupational segments) and even more severe disparities between workers of different generations. Italy was then, in the final years of its "economic miracle", consisting of a young and expanding labour force, high multifactor productivity, a very low unemployment rate (around 3% of the labour force) and a sustained GDP growth rate (about 5% p.a.). Political parties and trade unions thought that a general overhaul of the system would help "to ensure that, after 40 years of work and contributions, workers would be entitled to a pension based on 80% of the average wage of their last three years in employment". Three years later, Act 238 of the 18 March 1968 further specified the characteristics of the new scheme, aimed at establishing "the most advanced pension system in the world"; the following year, Act 153 of the 30 April 1969 introduced a general old-age pension for all Italians over 65 but devoid of any other income, with benefits indexed to wage increases and not to the cost of living (so pensioners would profit from increases in general productivity); it also allowed early retirement after 35 years of service (much less in the civil service and even lower for working mothers). As benefits were based on earnings in the last or best years of working life, and not on payroll taxes and contributions, the system was named a "pay-as-you-go earnings-related pension system".

Albeit maintaining an occupationally based system (and for certain categories providing for even more generous benefits than those described above), the legislation was to have met two main requirements: to compensate for inequities between the same generation (and related political tensions) and to allow older workers to reap the benefits of the "economic miracle" (Ferrera, 1994).

These objectives, however, could only be reached by a series of technical corrections to the mixed system based on both fully funded and pay-as-you-go schemes, as developed from the late 1940s to the late 1960s. Instead, the changes were strongly politicised. Workers and employers' contributions were no longer seen as a means to finance the system but as a levy on employers, often seen as the "exploiters" of the working class. Benefits were no longer linked to productivity and/or to financial yields but to the general purpose of maintaining the standard of living between a floor (minimum pensions) and a ceiling (maximum pensions), which would favour workers with comparatively less successful careers during their active life.

Just a few years after the overhaul, it was apparent that changes in demography and the labour market meant that the new system was not financially and economically sustainable in the long term; the ratio between active and non-active population had gone from 4.6 to 1 in the 1950s, to 1.2 to 1 in the 1990s. The system also had built-in incentives that would create new inequities as well as evasion of payroll taxes and contributions: employers and workers would tend to evade and elude payments for payroll taxes and contributions specifically earmarked to the pension system, except for the years relevant to the computation of the benefits. Inefficiencies, ineffectiveness and inequities were exacerbated, as Italy's economic and social structure changed from large manufacturing groups to burgeoning small enterprises, both in industry and services. The labour market also evolved from lifetime employment practices to increasing mobility from firm to firm, sector to sector and location to location.

Briefly, the 1965-69 reforms were based on faulty premises; an entire catalogue of what should not be done when re-adjusting pension schemes − even after the trauma of World War II and its aftermath. Already in the mid-1970s, it was clear that the 1965-69 system would not be financially, economically and socially sustainable in the long run. However, in just a few years, opportunistic free riding and cheap riding in the 1965-69 period made any reform extremely difficult.

For the Central and Eastern European countries, more significant than the faulty premise of the Italian 1965-69 reform is the change in social value systems and government objective functions underlying the successive structural adjustments in the Italian pension system. The initial compulsory system established at the beginning of the 20th century was basically considered as a social insurance mechanism to protect against the "risk of ageing": at the time, only a very limited proportion of the Italian population had a life expectancy at birth estimated to reach the pensionable age, and to benefit from retirement for several years. Thus, the funded system worked as an insurance scheme; it was compulsory and forced a virtuous circle of savings for old age on the paternalistic capitalism assumption that if left to their own whims and devices, individuals would not practice a virtue which, albeit private, had a strong public interest dimension: preventing putting on welfare rolls impoverished old men and women no longer able to work.

Such paternalistic capitalism (Papandreu, 1971) moulded the "Liberal Governments" of the earliest part of the 20th century, as shown, for instance, by their protectionist foreign trade policies (Pecorari, 1989; Iraci, 1996). Thereafter, it was an essential component of the corporate state during Fascism (Esping-Andersen, 1996). A young demographic structure, and public policies strongly in support of large family formation, was fully consistent with this view.

Also, after World War II, the change from a fully funded insurance based system and the pay-as-you-go mechanism mirrored not only the cash requirement to provide a steady in-flow to finance ongoing retirement claims after the depletion of funds retained by the insurance based social security institutions; its underlying assumption was to strive for intra-generational redistribution within a general background of a still quite young demographic structure and high growth rate of the economy (Janossy, 1966). As a matter of fact, at the time, the savings rate was quite high and channelled towards high productivity investments, both in the private sector and public infrastructure; thus, it appeared sensible policy to maintain living standards and consumption of people on retirement nearly at the same level they had reached in final phase of their working life; neo-Keynesian policies were then being introduced in Italy (Forte, 1966); a pay-as-you-go system was fully consistent with this approach and, in addition, appeared to satisfy also long-term intergenerational aspects by binding the mechanism and providing clear-cut entitlement.

The drastic transformation of Italian society in the 1970s and 1980s was not foreseen when the late 1960s reforms were designed and approved; rapid secularisation of a previously strong Roman

Catholic country had a major effect on gender roles and on family size. In parallel, the industrialisation model was drastically revised: from large plants in basic manufacturing to small and medium size firms in industrial districts; the rigidities of the formal labour legislation provided an added incentive to the growth of highly informal employment in the shadow sector (De Luca and Bruni, 1993). In parallel, the compulsory pension system was called upon to take up the slack in other areas of welfare policies (unemployment, disability) where Italy had lagged behind the other Western European countries; this resulted in the "maze" (Castellino, 1975). Conceptually, underpinning the "maze" there was a muddy and unclear objective function: from an insurance against the "risk" of becoming old to an instrument to sustaining living standard (*viz*. consumption) and providing a reasonable degree of intragenerational and intergenerational equity, the pension system had gradually became a catch-all device to meet many and often contrasting aims and objectives. This is at the root of the long, and still unfinished, journey toward reform started in the 1990s.

From this reconstruction, a key lesson stems for the Central and Eastern European countries now in the process of designing and revamping their pension systems: keep their objective function − *viz.* their aims and objectives − simple. And keep equally simple their design and make allowance for a sufficient built-in flexibility to adapt them to changing circumstances. As can be seen, the systems prevailing until the late 1980s were based upon a muddy objective function whereby pension had to carry the burden for the full gamut of social insurance, provided over-generous early retirement benefits, but no indexing, on the faulty assumption that in socialist countries, there would be no inflation, and thus no need for pension adjustments to price increases.

Attempts to reform the system in the 1980s and why they failed

It might help to recapitulate the attempts Italy made during the 15 years between 1978 and 1992, to remedy at least some of the most unsustainable, distorting and inequitable features of the 1965-69 system. The Italian public in general is not fully aware of these attempts, and they are seldom treated in Italian literature on pension reforms;[2] they provide, however, useful information for an international audience. They reveal that, contrary to conventional thinking, longer-term and structural changes in the pension system were promoted by the Ministers of Labour and Social Security rather than by the Ministers of Treasury; the latter were more interested in shorter-term financial issues and were generally satisfied enough if the annual budget and final accounts balanced, whilst the former often had a more far-sighted view. The attempts also show the positive and constructive role of the larger unions. The negative outcomes of these efforts prove one of the basic theorems of neo-institutional economics: faced with abrupt and far-reaching changes, the old institutions become more rigid and more "path dependent" (North, 1990), until a drastic exogenous determinant breaks them up. In sensitive areas like pensions, reform-mongers must have the capability to feel that such an external determinant is coming, and the capacity to join forces to seize it (Hirschman, 1990, 1991). These lessons may be quite pertinent to Central and Eastern European governments keen on reform.

In 1978-1980, after a major study of the pension system by an independent committee (including trade-unions and employers' representatives), the Minister of Labour, Mr. Scotti, attempted a four pillar rationalisation of the 1965-69 system: a) to gradually increase the pension age requirement (to 65 years for men and 60 for women; b) to harmonise the various social security regimes (at that time, nearly 120) under the overall pay-as-you-go pensions scheme; c) to modify the mechanisms allowing retirees to cumulate pensions and wages; d) to define new rules for self-employed workers; and e) to introduce incentives for private pension funds and other forms of individual retirement systems. After two years of negotiations and in spite of a change of government (although Mr. Scotti kept his position

2. For an exception, see Cazzola (1992).

as Minister of Labour), this rationalisation was blocked by the small and fiscally sensitive Republican Party. Their argument was that the transition costs would be high, because the programme included early implementation of an improvement in benefits for retirees at the lowest level of the income ladder; Mr. Scotti had to make this concession to the unions and to the Left-wing opposition.

In 1980, the new Minister of Labour, Mr. Foschi, obtained only marginal changes: a) an increase in the pension ceiling; b) streamlining of pension payments; and c) new procedures for computing certain forms of supplementary pensions. The key issues of financial, economic and social sustainability could not be tackled; indeed, they could not even be considered. The corollary of the minor changes introduced was a negative policy externality. Pushing for a very high level of legislative pension production for small particularistic reasons was the result of negotiations with small corporatist groups, rather than the major trade unions and employers' associations. This meant a limited vision rather than a broad, long-term view.

In 1982, the new Minister, Mr. Di Giesi, tried again to harmonise the over 100 "regimes" making up the system, and increase the pensionable age to 60 years for women and 65 for men. A bill was eventually drafted after consultations with unions and employers' associations; it sailed through the Council of Ministers, but parliament initiated a lengthy debate as to whether changes in the 1965-69 system would be constitutional, because of the discrimination they would produce between different categories and generations of workers. Parliament was dissolved, and new elections took place, before the critical sections of the bill came up for debate and voting.

In 1983-87, the Ministry of Labour had the same minister, the dynamic and energetic Mr. De Michelis, for a comparatively long spell of time. He charted a "great and general" pension reform, and his staff drafted four successive bills based on the increase in pensionable age and pension ceiling, on new procedures to calculate benefits, and on fiscal incentives and other instruments to promote pension funds. One of the bills was approved by the Council of Ministers; an extensive parliamentary debate ensued, with a flood of proposals for amendments from both majority and opposition; the legislature ended before the bill was fully examined.

After the 1987 general election, the new Minister of Labour, Mr. Formica, had two separate bills. Parliament only acted on the increase in the pension ceiling and on the lengthening to ten years of the period for the average wage to be considered for the computation of benefits. Fresh attempts were made in 1990 by the new Minister of Labour, Mr. Donat Cattin, and in 1991 by his successor Mr. Marini (a former trade union leader). The basic outlines were similar: a) gradual reduction of benefits; b) increase to 65 years of the eligibility requirement for both man and women; c) extension from 35 to 40 years for early retirement (at whatever age); and d) ways and means of promoting private pension funds. Even though transition to the new rules will not be completed until 2016, no action was taken.

Therefore, year after year, similar proposals were put forward, without any of them tackling the central issues. The failure to introduce even comparatively minor modifications cannot only be imputed to the overall resistance to change mentioned at the beginning of this section, but rather to the fact that in the 1980s the central policy issue in Italy was how to develop a non-inflationary growth path after the inflationary no-growth path of the 1970s (Graziani, 1998). This former was not only a requisite for participation in the European exchange-rate agreements but also had a high social priority because of increasing unemployment. Policies were thus focused mostly on wage and salary indexing and a benign neglect of pension matters was often used as a means to reach an agreement on these issues.

The 1992 financial and foreign-exchange crisis and pension reform

With the 1992 financial and foreign-exchange crisis, policy priorities shifted drastically to controlling public expenditure and to reforms in factor and product markets, including the pension system; this crisis was a real "turning point" in Italian development (Monorchio, 1996).

The reasons for the 1992 crisis were: a) a pegged exchange-rate mechanism which appeared to have stabilised exchange rates, but had not achieved an effective convergence of monetary and economic policies, b) a creeping overvaluation of the exchange rate with negative implications on export competitiveness, and c) a high level of short-term financing on the international market. In addition to these general causes, there were two specific political developments: a) at the European level, the high cost of German re-unification and scepticism of financial markets about the decision to move from the EMS (namely, an exchange-rate stabilisation mechanism through short-term financing mutual support) to a fully fledged European Monetary Union (replacing national currencies with a new currency, the euro) especially after the Danes had rejected the EMU and the French only approved it by a very slight majority; and b) in terms of public finance, Italy was the furthest from the EMU Treaty targets, Italian exports were losing ground because of the overvalued exchange rate; moreover the Italian ruling class was undergoing a series of judicial investigations and trials which increased market scepticism about the capability of the Italian emerging − and most likely inexperienced − political leadership to come to grips with the financial and economic requirements for joining the EMU. Between September 1992 and February 1993, in spite of massive interventions of the European central banks in the foreign-exchange market and the depletion of the Bank of Italy's foreign reserves (Banca d'Italia, 1993), the EMS nearly collapsed. Italy asked for a suspension from the exchange-rate mechanism and let its currency float; the Italian lira depreciated by nearly 30% on foreign-trade weighted average.

Against this background, the Italian government enacted a supplementary budget (Order in Council 333 of 11 July 1992) to increase revenues and reduce expenditures in the second half of 1992, with the hope of stemming the coming crisis. A second Order in Council (384) was approved on 19 September 1992, the day after the decision to leave the EMS and let the currency float; this order formed the basis of Act 421 of 23 October 1992 which envisaged a huge supplementary budget and prepared the ground for major reforms in the areas of pensions, public-health services, labour-market regulation and local authorities finances. There are three relevant points for the purposes of this paper: a) the government received "delegation authority" to change the pension system within general guidelines provided by parliament, without any requirements for negotiations with employers and trade unions; b) the pension reform was not isolated but went hand-in-hand with reforms in other key elements of the social safety net, such as public-health services and labour market; and c) the new pension policies (as well as health and labour market ones) were triggered by the financial crisis and formulated in a very short period, thus lacking the long-term vision required to design a sustainable, effective and efficient new system.

The main aspects of the 1992-93 pension reform (called "the Amato reform" after the Prime Minister then in office) are as follows:

- The retirement age was established at 65 for men and 60 for women, starting in 2002.

- The eligibility for old-age pension was extended from at least 15 to at least 20 years of contributions; the earnings mechanism for computation of old-age benefits was drastically revised for those with less than 15 years of contributions when the new legislation became effective: reference earnings were extended from the last ten years to the whole working life with adjustment of past earnings for inflation and 1% real growth.

- The yield coefficient of the various schemes was harmonised at 2% p.a. (with a few notable exceptions for certain powerful occupational categories).

- The indexing of pensions was based on cost of living, not on real earnings indexes, with the possibility, however, of future legislative adjustments if great differentials between real earnings and inflation emerged due to a greater than estimated growth in productivity.

- The contribution rates were set at 26.5% of earnings (two-thirds for employers) for employees and 15% for the self-employed.

- The pensionable age for seniority and long-term service pensions was raised to 35 years of contributions for all workers.

- A 15% withholding tax was introduced on funds deposited for private pension funds.

In short, the "Amato reform" did not change the basic design of the pay-as-you-go pension scheme designed in the late 1960s (section 2 above). It revised downward benefits by extending the reference period for earnings to be included in the computation [see c) above], by reducing the yield and especially [see d)] by revising indexing [see e)]. This last measure proved the most effective in terms of reducing future pension expenditures (Ministero del Lavoro e della Previdenza Sociale, 2001*a* and *b*). On the other hand, however, the "Amato reform" introduced very serious discrimination between workers by sharply differentiating the benefit computation procedure between those with less than 15 years of contribution and the others. It thus drastically heightened intergenerational inequities. More significantly, as an emergency measure, it did not tackle the basic conceptual flaws of the "pay-as-you-go pensions scheme". Albeit saluted as the definitive pension reform, to be taken as a standard by all European and non- European countries (INPS, 1993), the following year the new government had to introduce a temporary freeze with Act 537 of 21 December 1993. After the 1994 election, the government once more had pension reform as one of its main items on the political agenda. However, the government coalition dissolved precisely on the pension reform issues and, more specifically, on the proposal to abolish seniority pensions and drastically revise the benefit computation mechanism. A technical non-elected government was convened by the President of the Republic and received parliamentary approval. A new financial crisis was looming with downward pressures on the exchange rate and upward pressures on interest rates (Tivegna and Chiofi, 2001). Under pressure from the market but not in the wake of an overall crisis, the pension system was finally overhauled.

The 1995 reform

Following the measures enacted in 1992, in 1995 Italy introduced a major reform of its pension system. As described before, the 1992 reform was targeted to improve the financial sustainability of the pension system, basically by abolishing the indexation to real wages, as well as by extending the period of the reference earnings on which the pension benefits would be computed. The 1995 reform, instead, aimed at stabilising the incidence of pension expenditure on GDP, at increasing the efficiency of the labour market by reducing its distortions and the tax on labour, and at making the overall pension system more equitable.

The 1995 reform strongly modified the basic structure and functioning of the pension system. To strengthen the relationship between benefits and contributions paid on an individual basis, the government decided to eliminate the earnings reference for computation and to introduce a notional defined contribution mechanism: benefits are strictly tied to contributions paid during the working career through the application of a special transformation coefficient on the total amount of notional

contributions paid during the working years. The coefficient is deemed to be fair on an actuarial basis. Essentially, the reform implied a shift from a defined benefit to a defined contribution scheme, according to which the notional accumulated contributions are transformed into an annuity upon retirement.

The main characteristics of the reform are the following:[3]

a) The pension benefit is computed by multiplying the balance of the individual account by an age-related conversion coefficient that renders the present value of future benefits equal to capitalised contributions. This coefficient can be updated and modified every 10 years on the basis of changes in life expectancy at birth of the overall population, of the rates of growth of GDP and of earnings assessed for social security contributions.

b) The age of pension becomes flexible and workers can choose it at any year between 57 and 65.

c) The social security payroll tax rate was increased up to 32.7% of wage/salary to reduce the structural revenue-expenditure imbalance of the public pension fund for employees in the private sector (Table 10.1 shows the history of social security contribution tax rate and the increases expected in the near future); it is worthwhile to note the significant increase of the tax rate realised for the sector of craftsmen and shopkeepers, which should take these categories to the level of nearly 20% by the year 2010 (Table 10.1).

d) Because of the current political and social constraints, the reform implementation will be very gradual and initially concern only people who began working after 1995, who will receive a pension entirely calculated on the basis of new rules. The reform segmented the present universe of pensioners into three groups of beneficiaries: those with more than 18 years of contributions in 1995, who will be subject to the same rules existing before the 1992 reform (the earning scheme); those with less than 18 years of contributions, who will be submitted to a *pro rata* regime, in the sense that the new rules established in 1995 will be applied only to contributions paid after that date; and finally, the last group of newcomers, who started to pay contributions after 1995, and who will be subject to the new scheme. Finally, in 1997, another set of measures was proposed by the government and enacted by parliament with the aim of unifying the different pension regimes and revising the seniority pension system.

The reforms introduced in the last five years in Italy have influenced those being carried out in Sweden and Germany, especially in terms of structure of the pension system and of the notional contribution mechanism to compute benefits. They have meant major changes in the Italian pension system; however, as indicated, the transition will be very gradual and the reformed system will produce benefits only in the long run, *viz.* in 15-20 years; it is estimated that the new system will come fully into effect only in 2070, because the last beneficiary of survivors' pension would have passed away. In the short run, the efficiency, effectiveness and equity issues will tend to remain unchanged and unresolved; further measures already seem to be needed, and at present are being prepared by the government, and negotiated with the unions and the employers' associations.

3. See Franco (2000); Sartor (2001).

Issues to be resolved: prospects for further development

The Italian pension system still needs a major structural reform which, by taking seriously into account the future demographic structure and labour market conditions, can definitively stabilise the ratio of pension expenditure to GDP in the long run, and usefully develop a funded pillar.

A recent government Commission[4] has reviewed and ascertained the positive financial effects of the 1995 reform. These reforms have had significant implications on the rate of growth of pension expenditure: in fact, as shown in Table 10.2, the average rate of increase of pension expenditures has consistently slowed down during the last few years: *e.g.* from an average annual rate of increase of 12.2% in the 1990-1992 period, to 3.1% rate in 1998-2000. The most significant reduction in the rate of growth has been achieved in the area of pension payments for private sector employees; from an annual rate of 11% in 1990-1992 to an average increase of 2.6% between 1998 and 2000. A less significant slowdown in pension expenditure has been achieved in the sector of craftsmen and shopkeepers (from 14% in 1990-1992 to 6.1% in 1998-2000). In the public sector the slowdown has been significant (from 15.9% to 4.4%) albeit the average annual rate of expenditure growth remains still high in relative terms. There has not been a significant decline in living standards for current retirees; such a decline, however, may be inevitable for future cohorts of retirees as a consequence of the ageing of the Italian society, as well as the need for further reforms.

A confirmation of the importance of the measures already implemented in Italy comes from Table 10.3, which shows the projections of public pension expenditure as a ratio of the GDP up to 2050. The incidence of Italian pension expenditure on GDP will remain somewhat stable until 2020. However, from 2020 onward, the baby boom generation will reach retirement age; this will cause a modest rise in the level of expenditure (15.9% of GDP in 2030, 15.7% of GDP in 2040) which would then decline to 13.9% in 2050.

The process of retirement of the baby boom generation will take place in Italy (especially between 2030 and 2040) and also in other important countries (notably, Spain and Germany); it is mirrored by the evolution of the old-age dependency ratio within the countries of the European Union, as shown in Table 10.4. The ageing of the Italian population will significantly increase and the old-age dependency ratio will reach in 2040 and in 2050 63.9% and 66.8%, respectively. Therefore, notwithstanding the results obtained with the reforms of the last few years, Italy needs more incisive measures for the long term, so as to increase the average age of retirement and the rate of employment of the cohort of people aged between 55 and 65. As the period under analysis is still relatively short − five years − there are no data available on the 1995 reform incidence on savings and investments or on employment patterns.

To improve the current situation, there are some possible directions of reform:

a) A feasible way could be to improve the actuarial mechanism introduced in 1995, by strengthening the link between benefits and contributions on an individual basis, for example, with the abolition of any differences between the computation rate and the financing rate in the assessment of contributions.[5] An additional measure could be to unify the system of

4. See Ministero del Lavoro (2001*a*).

5. The computation rate is the basis for calculation of pension benefits; the financing rate is the actual rate levied on wages and salaries. There are major differences in financing rates between various categories of workers and, thus, of future beneficiaries, especially between those in wage/salary employment and those in self-employment.

pension indexation to the increase of nominal GDP and not to the retail price index. Finally, to equalise the rates of return for different individuals, it could be necessary to apply new rules for the computation of benefits to everyone, even to those who had paid more than 18 years of contributions in December 1995 (pro rata method). This set of measures would have the political advantage of leaving the basic design of the 1995 reform mostly unchanged; indeed, this design would be carried to its logical implication, since the political conditions to fully implement the new conceptual framework did not exist six years ago (Gronchi, 1997).

b) Another possibility would be to move to a mixed pension system, by creating a new fully funded pillar with the old pay-as-you-go scheme, to spread the risk of pension accumulation more efficiently over two pillars. The practical solution would be to let people opt out voluntarily from the public pay-as-you-go system and to shift a share of the current flow of social security contributions of all workers to private pension funds. The new scheme could be a two or a three pillar system where, in addition to private personal plans, occupational pension plans would also be allowed. This solution would strengthen property rights on resources accumulated and therefore would strongly limit the interference of politicians in pension matters (the political risk). A two-three-pillar system could better diversify the economic, demographic and financial risk of pension accumulations and increase the consensus of workers enrolled in the new mixed system on the rules of the game. Any change would be very visible and therefore politicians would have their hands tied and their possibility of manipulation reduced to the minimum (Pennisi, 1997; Castellino, 1998; Fornero, 1999; Amato and Marè, 2001).

c) To give more flexibility to individuals in the choice of their pensionable age: for example, by offering fiscal and monetary incentives to workers who decide to remain in their jobs[6] and by allowing people to add income from an independent activity to that from their pension.[7] These measures could stimulate individuals to postpone the date of retirement, with an evident cut in overall pension benefits; they would also reduce the area of the irregular economy, with evident benefits for the growth of employment, the base of social security contributions and the national income (Vitaletti, 2000).

d) To introduce a fully-funded pension system run by the government. Such a system would be, by and large, modelled on a compulsory provident fund. Transition would take nearly seventy years and, in the initial decades, would require an increase in overall contributions, as well as the transfer of sums currently set aside for severance payments into new funds. First of all, the transition period would be overly long and cause a further increase in overall labour costs. More significantly, at the eventual steady stage, there would be enormous corporate governance issues, because the new fund would *de facto* become a major stockholder of all Italian large and medium size firms (Modigliani *et al.*, 1999).

Whichever route is eventually selected, the average level of benefits is likely to decrease, but the pension system would become more equitable, more efficient and more effective in targeting to low income social groups.

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6. For example, by allowing people who decide to postpone retirement to receive a part (or the total) of the tax wedge.

7. The so-called "possibility to cumulate income from labour to the income from pension" (the cumulo).

Lessons to be learned from the Italian experience

The main findings of the review of the Italian experience with the pension reform are the following:

a) Pension and welfare systems are the result of a delicate balance of economic, social and political power. Shocks may forestall reforms but they can also accelerate them. Students of market-supporting institutions know that sometimes several large shocks are needed for change (Rajan and Zingales, 1998). For policymakers and politicians, periods of crisis can sometime provide opportunities, at least in certain particularly critical sectors, to undertake bolder institutional reforms − and these opportunities are to be seized. In a seminal book, Timor Kuran (1995) shows how a crisis can break through "public lies" and "the process of preferences falsification" in economic and social policies, especially in such sensitive sectors as pension and welfare systems and reforms. More recently, Dani Rodrik (Rodrik, 2000) demonstrates how crises forestall conservative attempts by the "political losers" not to change obsolete institutions; if properly nurtured, they can be a lever towards high quality institutions. In Italy, as well as in other European countries, the 1992 foreign exchange and financial crisis, first, and the path towards EMU, later, have gradually moulded a major change in the unions' outlook, which in the past had often been a stumbling block in pension, welfare and labour market reforms: from a corporatist and conservative posture in favour of the "old institutions" of the "old economy" to a broader, more socially responsible attitude geared to ease the transformation process (Bertola *et al.*, 2001; Boeri *et al.*, 2001), toward a flexible high value-added production structure. "Nurturing" towards reform as well as towards higher quality institutions in the social policy area, however, is a difficult process by itself. The Italian case shows that reforms were feasible, and were made, under the Damocles' sword of the foreign exchange and financial crisis (in 1992) and of the threat of being denied access to the Eurogroup of EMU founding fathers (in 1995-97). Thereafter, the momentum has been gradually lost; in spite of the opportunity for designing a new and definite reform with a longer view and without an emergency policy framework, no substantive action appears to have been taken after the 2001 "check-up"; none of the five models for further development illustrated in this paper, nor a combination of them, is being selected for the needed further changes and reforms. If properly nurtured, the recent slowdown of the world economy and fear of a new wind of crisis, may be seized as an opportunity by reform proponents. Central and Eastern European countries share many points with Italy: once again, after the contractions in real income and public revenues in the 1990s, there are opportunities to be seized by reformers intending to establish an efficient, effective, sustainable and equitable social safety net. Indeed, quite a few countries (the Baltic Republics, the Czech Republic, Hungary and Poland) developed a variety of multi-pillar schemes in the second half of the 1990s, and now the main policy objective should be to fine-tune them.

b) The 1992 and 1995-97 reforms and models for further development summarised in this paper are all, by and large, based on moving from a one pillar pay-as-you-go system to a two or three pillar system with an increasing role, and a fully funded scheme. On the suggestion from Western, mostly American, advisors, Central and Eastern European countries are attempting to develop pension systems mostly anchored to fully-funded mechanisms. The review of the theoretical models raises some doubts about the conventional wisdom on funded systems, on their advantages and costs; there are basically three major points:

i) Can a funded system guarantee higher real returns?

The most frequent reason given in the pension debate for a funded system is the apparently superior performance of the capital market in terms of the rate of return on investments. Between 1960 and 1990, most pay-as-you-go systems have indeed offered elevated returns to the first generation enrolled, often higher than rates provided by the market. This was possible because at that time the pay-as-you-go systems had not yet reached maturity, and had benefited from high GDP growth rates and rising contributions on wages. However, after 1990, the basic scenario dramatically changed. Looking at real yields of investments in financial markets during the last 30 years, very high real returns can be noted. A recent study by Siegel (1999) shows for the United States an annual real rate of returns in the order of 6-7% − for stocks and shares − while some other works by Jorion point out rates between 4 and 5% for the US.[8] Hence, pension funds with investments in financial markets for a sufficiently long period of time seem able to provide very high real rates of return. A simple comparison between the returns of the two different pension systems, easily leads to the conclusion that the shift to a funded system shows evident advantages in terms of rates of return. But this is true only if the *pure returns* of the two systems are compared. The advantage tends to fade − if not to disappear − if *transition taxes* are also considered, that is, the taxes − the tax burden − that the generation which is making the transition to the new system will have to bear in order to finance (and pay) for existing pensions.[9]

ii) Does a new funded system imply an improvement in the economic welfare of society as a whole?

Many authors have expressed quite different opinions on this point. Some authors (Feldstein, 1998; Kotlikoff, 1998) have constructed models that generate efficiency gains from a transition to a funded system; others (Diamond, 2001; Geanakopolos *et al.*, 1999) have argued that a welfare improving transition to a funded system is not possible. In general terms, the answer is no. The advantages for future generations tend to be somewhat offset by costs on present generations. A more interesting point is to question whether funding is able to increase national savings and the stock of capital; whether it can stimulate the growth of financial markets and in this way increase national income. If the pie becomes bigger, then the distribution conflict between generations, which inevitably rises on the transition to a new pension scheme, can be successfully alleviated.

iii) Does funding insulate from demographic shocks?

As the ageing of population tends to have a certain effect on funded schemes too, an older population will also end up affecting funded pension schemes. Sooner or later, pension funds will have to sell their assets to a diminished active population; and if a given stock of assets is sold to a lower number of buyers, the price of assets can be negatively affected, with evident repercussions on the resources available for pensioners.[10]

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8. This figure does not include dividends. Goetzman and Jorion (1997) show, in the period between 1970 and 1995, for the UK a rate of 6.39%, for Germany 5.5%, for the Netherlands 8.8%, and 4.45% for France.

9. The same applies if the payment of existing pension rights is financed with the issue of public debt; in fact, someone has to shoulder the burden of interest related to this debt (the debt service), and this is equally true for new taxes.

10. Or, if the elderly people in the goods market demand a higher amount of goods than those currently produced by active people – pensioners' desired consumption exceeds workers' desired savings – this will cause price inflation, reducing the purchasing power of pensioners' annuities.

Finally, the Italian experience proves that pension reforms soon and easily come to a standstill if they are not included in broader welfare-state and labour-market institutional reforms. As indicated in section 1 of this paper, a feature of the Italian social welfare system is its concentration on pensions; for this reason, pension reform became a visible and high priority issue in the 1992 crisis and in the 1995-97 path towards EMU. This is more apparent in Central and Eastern Europe due to the heavy burden placed on pension as catch-for-all social insurance instrument.

In Italy, the highlight on pension reform, albeit essential, diverted focus from another and lesser known feature of Italian social policies: taxes-and-transfer schemes have very poor targeting properties among people of working age and in general, weak anti-poverty properties. Modest attempts were made after 1995 to remedy this situation but they have been mostly unsuccessful; and the lack of an efficient monitoring and evaluation system has meant that very little has been learned from them. "Less pensions, more welfare" is not merely a slogan but a call to broadly revamp social policies (Boeri and Perotti, 2001). Such a call must include labour market reform towards flexibility and decentralised wage bargaining as well as breaking down the barriers between the formal and informal employment sector (Pennisi, 1997) only such a broader social policy adjustment would prevent pension reforms from coming to a halt in a loop with the other elements of the welfare state. The recent government "white paper" on labour policies (*Ministero del Lavoro e delle Politiche Sociali*, 2001*b*) augurs well. If the Italian pension system is gradually transformed from an essentially one pillar pay-as-you-go system to a two- or three pillar system with a growing fully funded leg, the emphasis should be on integrating the fully funded pension element with unemployment insurance through individual savings accounts (Stiglitz and Yun, 2001) an approach which many Central and Eastern European countries could also find useful.

Relevance of the Italian experience to Central and Eastern Europe

How pertinent is the Italian experience to the Central and Eastern European countries? Even though there are many differences in general socio-economic development between Italy, at a glance, and the Central and Eastern European systems, there appear to be many similarities to what the Italian pension system used to be before the reform of the 1990s: in Italy the overall ratio of contributors to pensions is 1,3:1 and in Central and Eastern European countries varies from 2:1 and 1:1 as follows: Albania 1:1; Bulgaria 1,2:1; Czech Republic 2:1; Hungary 1,5:1; Poland 1.9:1; Romania 2:1; Russia 1,9:1.

Demography and employment trends are, no doubt, similar determinants: both Italy, on the one hand, and Central and Eastern European countries, on the other, are ageing societies. Italy has low employment rates as compared to the rest of Western Europe, whilst unemployment, disguised until the late 1980s, has exploded as a major issue in Central and Eastern Europe during the 1990s. However, behind these rough indicators, there are also major differences: in Italy, in many households, there are individuals collecting several pensions, whilst in Central and Eastern Europe, the low average number of contributors mirrors weak enforcement, poor administration and a high rate of evasion. Also as indicated above, in Central and Eastern Europe, the lack of indexing has caused a severe erosion of pensions in real terms at a level below those of the poverty line or even the subsistence line,[11] whilst on average, Italian pensions are reckoned to be rather generous by international standards.

11. The poverty line is expressed in monetary terms; conventionally, for a household of two, and is the level equivalent at half the per capita income: appropriate scale adjustments are made for larger households. The subsistence line is expressed in calories and varies with climatic conditions.

In line with most Western European retirement schemes, the Italian pension system is universal in that it covers all the population in the formal employment sector; indeed, it provides basic social retirement income to older workers in the informal sector.[12] Not all the Central and Eastern European systems are universal, even though after the reforms started in the 1990s, they tend to cover all the aged population. The structure of the Italian pension system is founded upon a few large public sector institutions, running over 50 different retirement schemes still in the process of harmonisation and eventual unification; a similar process of consolidation is in process in many Central and Eastern European countries. More significantly, the Italian pension system is a mature system; indeed, it is a system that has not aged very well, and is still plagued with many fundamental issues in the areas of fiscal sustainability, equity, efficiency and effectiveness. After the reforms introduced in the last few years, the Central and Eastern European systems can be considered comparatively young and untested.

The second question is whether the lessons from the Italian experience are nonetheless useful to build a well-conceived pension development path. A two-pronged approach appears suitable: a funded social insurance system for those in large and medium size firms (as well as in public establishments) and a gradually extending general basic core system for those in the rest of the modern wage sector, whereas other, more specific and better focused and targeted instruments should be used to attack poverty and destitution in urban areas and shanty towns. This two pronged approach has an important implication: on the one hand, the pension system would become a unified two or even multi-pillar system (an universal basic core system complemented by employment based pension funds and incentives to individual pension accounts); on the other hand, retirement schemes and other poverty alleviation and eradication objectives, and related instruments, would be clearly kept quite distinct from the pension system. Thus, the muddle between the pension system and other elements of the social protection policies would be avoided.

Looking more closely at the Italian experience, it appears that two other faults of the Italian case can be kept at bay. First, the multi-pillar system could evolve quite naturally; to set it up, there would be no need of a series of difficult reforms similar to those on which Italy embarked herself since the early 1990s, under the pressure of financial crises as well as of the requirement for EMU membership. Second, the universal basic core pillar could be financed from general tax revenue, rather than by contributions or various forms and means of payroll levies. Indeed, in its infancy and initial stages, the basic core pillar can be seen only as financed on the Exchequer because of the huge administrative costs to exact contributions from the small enterprises and semi-informal sector. This may make Central and Eastern European pension systems path dependent on a virtuous trail, rather than on the vicious avenue chosen by Italy in the late 1960s and still at the roots of many current difficulties.[13]

12. Estimated to be equivalent to between 20% and 30% of total formal employment.

13. An interesting comparison can be made between the reformed Polish system closely patterned on that stemming from the Italian 1995 reform (Office of the Government Plenipotentiary for Social Security Reform, 1997), and the Hungarian reformed system, more strongly oriented towards fully funded private pension funds (Palacio and Rocha, 1997).

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Table 10.1. Social security payroll tax rates in Italy

Year	Private sector employees	Craftsmen		Shopkeepers	
		Lump sum contribution (lire)	Tax rate	Lump sum contribution (lire)	Tax rate
1960	14.41	7 778	0	0	0
1965	18.58	14 928	0	0	0
1970	20.56	14 928	0	14 928	0
1975	20.77	72 528	0	72 528	0
1980	23.90	428 416	0	429 236	0
1985	24.51	944 620	4	941 121	4.20
1989	25.92	1 358 780	4	1 355 280	4.20
1990	25.92	0	12.00	0	12.00
1991	26.09	0	12.75	0	12.75
1992	26.49	0	13.50	0	13.50
1993	26.97	0	14.29	0	14.29
1994	26.97	0	15.00	0	15.00
1995	27.16	0	15.00	0	15.00
1996	32.70	0	15.00	0	15.09
1997	32.70	0	15.00	0	15.39
1998	32.70	0	15.80	0	16.19
1999	32.70	0	16.00	0	16.39
2000	32.70	0	16.20	0	16.59
2002	32.70	0	16.60	0	16.90
2004	32.70	0	17.00	0	17.30
2006	32.70	0	17.40	0	17.70
2008	32.70	0	17.80	0	18.10
2010	32.70	0	18.20	0	18.50
2012	32.70	0	18.60	0	18.90
2013	32.70	0	18.80	0	19.10
2014	32.70	0	19.00	0	19.30

Note: Even after the 1995 reform, pension payments are not based on actual payroll tax rate contributions, but on notional contributions significantly higher than the payroll tax rates.

Source: Ministero del lavoro (2001*a*).

Table 10.2. Average rate of increase of pension expenditure in Italy (%)

Sector	1990-1992	1993-1997	1998-2000	1990-2000
Private sector employees	11.0	6.3	2.6	6.6
Public sector employees	15.9	8.8	4.4	9.6
Independent workers	11.1	9.1	3.0	8.0
of which				
Craftsmen and shopkeepers	14.0	12.7	6.1	11.3
Total	12.2	7.3	3.1	7.5

Source: Ministero del lavoro (2001a).

Table 10.3. Projections of public expenditure on pensions as % of GDP in EU countries

	2000	2005	2010	2020	2030	2040	2050	Maximum difference
Belgium	9.3	8.7	9.0	10.4	12.5	13.0	12.6	3.7
Denmark	10.2	11.3	12.7	14.0	14.7	13.9	13.2	4.5
Germany	10.3	9.8	9.5	10.6	13.2	14.4	14.6	4.3
Greece	na	na	na	na	na	na	na	na
Spain	9.4	9.2	9.3	10.2	12.9	16.3	17.7	8.3
France	12.1	12.2	13.1	15.0	16.0	15.8	na	3.9
Ireland	4.6	4.5	5.0	6.7	7.6	8.3	9.0	4.4
Italy	14.2	14.1	14.3	14.9	15.9	15.7	13.9	1.7
Luxembourg	7.4	7.4	7.5	8.2	9.2	9.5	9.3	2.1
Netherlands	7.9	8,3	9.1	11.1	13.1	14.1	13.6	6.2
Austria	14.5	14.4	14.8	15.7	17.6	17.0	15.1	3.1
Portugal	9.8	10.8	12.0	14.4	16.0	15.8	14.2	6.2
Finland	11.3	10.9	11.6	14.0	15.7	16.0	16.0	4.7
Sweden	9.0	8.8	9.2	10.2	10.7	10.7	10.0	1.7
United Kingdom	5.1	4.9	4.7	4.4	4.7	4.4	3.9	0.0

Source: EPC (2000).

Table 10.4. Old-age dependency ratio in the EU countries

	2000	2010	2020	2030	2040	2050
Belgium	28.1	29.4	35.6	45.8	51.3	49.7
Denmark	24.1	27.2	33.7	39.2	44.5	41.9
Germany	26.0	32.9	36.3	46.7	54.7	53.3
Greece	28.3	31.6	35.8	41.7	51.4	58.7
Spain	27.7	28.9	33.1	41.7	55.7	65.7
France	27.2	28.1	35.9	44.0	50.0	50.8
Ireland	19.4	19.1	24.5	30.3	36.0	44.2
Italy	28.8	33.8	39.7	49.2	63.9	66.8
Luxembourg	23.4	26.2	31.0	39.8	45.4	41.8
Netherlands	21.9	24.6	32.6	41.5	48.1	44.9
Austria	25.1	28.8	32.4	43.6	54.5	55.0
Portugal	25.1	26.7	30.3	35.0	43.1	48.7
Finland	24.5	27.5	38.9	46.9	47.4	48.1
Sweden	29.6	31.4	37.6	42.7	46.7	46.1
United Kingdom	26.4	26.9	32.0	40.2	47.0	46.1
EU15	26.7	29.8	35.1	43.8	52.4	53.4

Source: EPC (2000).

Chapter 11

THE DUTCH PENSION SYSTEM: RISKS AND REFORM

by
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Introduction

Pension systems are at the heart of the public debate in all OECD member countries. Can the well-being of the elderly be guaranteed in a financially sustainable way, given the consequences of the ageing populations? This question has to be answered in all European countries. When everyone has to answer the same questions, it is good to learn from each other. The author considers that this OECD conference is a very good platform for sharing experiences.

This chapter discusses the following points:

- The Dutch pension system.
- The risks ahead, ageing and low real interest rates.
- The reform of the Dutch pension system.

The Dutch pension system

Characteristics

The Dutch pension system has some characteristics that differ from those of most others:

- About 40% of Dutch pensions are capital funded. This percentage will rise in the coming decades.
- The pay-as-you-go (PAYG) part is totally independent from the labour market history of a pensioner.
- The capital funded part contains elements of solidarity within and between generations.

Three pillars

In its most basic form, the Dutch pension system is a three pillar system. The first pillar is the responsibility of the government, the second pillar is organised by social partners in companies or industries, and the third pillar of individual responsibility.

The state pension, Algemene Ouderdomswet (AOW), is a national pension scheme which guarantees every resident of the Netherlands a basic pension from the age of 65. Labour market history does not influence the claim. The AOW is a flat rate pension paid out monthly and linked to the statutory minimum wage. A married pensioner receives 50% of the net minimum wage. This gives a couple 100%, each month, around EUR 1000. A single person receives 70% of the minimum wage. The AOW is a pay-as-you-go (PAYG) scheme, which is financed by social security contributions by people under the age of 65. The AOW is not means-tested; it is index-linked to the average development of collective labour agreements on wages.

The second pillar consists of the occupational pensions. These work-related pensions supplement the state pension. Occupational pensions can be regarded as deferred wages. For this reason, the social partners, employers and employees, are primarily responsible for the occupational pensions.

The last, and comparatively the smallest pillar, are the individual personal pensions. They can be funded through tax-deductible annuities.

Occupational pensions

Of the three pillars, the first and second are the most important. In 2000, almost 50% of the income of the elderly came from the AOW pension, 40% from supplementary pensions, and 10% from the third pillar. The second pillar plays a very important role in the Dutch pension scheme, and its role will grow in the coming decades. Because it differs from the pension schemes in most of the European countries, the author, in his introduction elaborates on some specific aspects of the second pillar.

The law does not require the social partners to make agreements regarding these pension schemes. It is all up to the social partners. They are firstly responsible for the supplementary pensions. The Dutch pension law does not oblige employers to give their employees a pension.

This does not mean there is no government intervention.

- The government safeguards pensions. When social partners agree on supplementary pensions, employees must be sure that these pensions will be paid to them. The money intended for supplementary pension schemes may not be included in the company's risk capital. The scheme must be fully funded.

- The government can bind non-organised employers in a branch to a branch pension fund. This only takes place on request of representative organisations of employers and employees in a certain branch, which means that at least 50% of the employees in certain branches are working for employers who are members of the employer's organisation.

- The government stimulates pensions with preferential fiscal treatment. Contributions for supplementary pensions are tax-deductible. As a consequence, the benefits are taxed as income.

- The government makes sure that equal cases will get equal treatment. It is not allowed for women to get a lower pension than men, nor that employees working part-time are excluded from a pension plan.

- The government promotes a healthy economic environment. Only in such an environment can social partners dare to save money for later.

The occupational pensions in the Dutch pension system are the result of interaction between government, social partners and an independent supervisor: the Pensions and Insurance Supervisory Authority.

- The government decides on the rules of the game (capital funding and safeguarding).

- The social partners decide the schemes. The content of the agreement on pensions is their responsibility.

- The Pensions and Insurance Supervisory Authority supervises the observance of the rules of the Pension Act. Therefore, pension funds and insurers are obliged to inform the Authority annually and in detail about the way they have calculated the actuarial provisions, and how they have funded these provisions.

In the second pillar, several types of pension scheme can be distinguished. By far the most common are defined benefit schemes. In these schemes, pensions are linked to the income from labour when the pensioner was still an employee. Generally speaking, most pension schemes aim to pay out 70% of the career average salary, or 70% of the final salary. Schemes based on the final salary account for by far the biggest proportion of schemes. Economically, these schemes imply solidarity between generations. Defined contribution schemes are much less common in the Netherlands.

To get 70% of final or average pay, employees must have contributed the full period of contribution, mostly 40 years. This targeted level of 70% of final or average pay incorporates the state basic pension of the first pillar.

The rules on administration of the second pillar are quite simple. The social partners can choose where they would like the pensions to be administered. The pension law offers three possibilities:

- The majority of pensions in the Netherlands are administered by branch pension funds. These are funds that operate in a particular branch or industry. Representatives of employers and employees in this branch administer those pension funds together. All employers in a particular branch may be obliged by law to participate in the branch pension fund.

- The second possibility for pension schemes to be administered are the company pension funds. If a sector does not have a compulsory pension fund, companies often set up their own pension fund to provide their workers with supplementary pensions. Although company pension funds are linked to a company, the company and the fund are totally separated legal entities. The employers and employees also administer these funds.

- Finally, it is possible to set up a collective agreement with an insurance company. If the employer does not fall under a compulsory sector pension scheme and setting up a company pension fund would be too expensive, the most common option is to arrange a pension scheme with an insurance company.

As may be noted, the Dutch pension funds are “closed”. They are only open to the companies or branches that are related to them. There is in the Netherlands no “competition” between pension funds. And there is also no need for “competition”. The branch and company pension funds are linked to specific branches or companies. The social partners in these branches or companies decide on the pension schemes, they pay the premiums and administer the pension fund. Because they pay the premiums themselves, they have the best incentive for effective and efficiently governed pension funds.

The pension funds and insurers have accrued a very large capital in the last decades. At this moment more than EUR 450 billion have accumulated in the pension funds. This amount of money is more than the yearly Dutch GDP. It is expected that in 2040, the pension funds assets will have risen to almost twice the Dutch GDP.

The pension fund assets of today are the pensions, the income for the next generation of elderly. This means that the pension funds should be well supervised. The Netherlands has chosen supervision based on qualitative principles such as safety, returns and reliability. No quantitative investment restrictions are necessary to safeguard the pension fund assets, neither a limitation on assets invested in equities, nor a limitation on assets invested in foreign countries.

The independent Pension and Insurance Supervisory Authority monitors whether pension funds comply with legal regulations. The Authority ensures that pension funds spread their risks evenly and that these funds have sufficient assets available, in order to meet their financial obligations, while taking into account the different circumstances of each fund. There is one general rule − the bigger the surplus reserves, the more risky bearing the investments can be. Where there is no such surplus, however, strict rules are applied in order to safeguard returns. In these circumstances, the Pension and Insurance Supervisory Authority can forbid a pension fund to invest their assets in the stock market.

To summarise, the important characteristics of the Dutch pension system in the second pillar:

- Very important role for social partners.
- Capital funded.
- Safeguarding of individual pension rights by government intervention.
- Good, independent and qualitative supervision by the Pension and Insurance Supervisory Authority.

Risks ahead, ageing and low real interest rates

There are always two main risks for pension systems:

- Pay-as-you-go systems will be difficult to finance when populations are ageing fast.
- Capital funded systems are sensitive to changes in the real rate of interest.

The Dutch pension system is partly insured for these two risks. When the population ages, the consequences will be felt only in the first pillar state pension system: and changes in real interest will have impact only on the capital funded second pillar systems.

Ageing

Like all other European countries, the Netherlands will be confronted with an ageing population. The total population over 65 will double between 2000 and 2040. It is expected that the ratio of the number of people over 65 years to the number in the age group between 15 and 65 will rise from 22.1% in 2000, to 42.7% in 2040.

The Dutch government expects that government expenditures due to ageing will rise by 9% of GDP between 2000 and 2040. This rise can be divided into:

- 4.3 percentage point GDP rise in expenditures for first pillar pensions.
- 3.6 percentage point GDP rise in health expenditures.
- 1.1 percentage point GDP rise in other expenditures (*e.g.* disability benefits for those under 65 years of age).

The expenditures for the second pillar pensions will almost stabilise at the current level of 7% of wages. As already stated, the second pillar is capital funded, which means that at this moment, the future pensioners are already saving for their pensions.

The second pillar will in part finance the expenditures of the government on ageing. The wealth of pension funds has never been taxed. Pension premiums in the Netherlands are exempted from taxes, but the pension benefits will be taxed as income. When ageing is reaching its peak and government expenditures rise, pensioners will receive pension benefits, which will then be taxed. It is expected that government receipts of the taxation of pensioner's benefits will be approximately 5% of GDP yearly. This means that the rise in the costs of first pillar pensions is expected to be roughly the same as the rise in taxes on second pillar pensions.

This income from future taxation does not imply that no further action is necessary. Health expenditure will rise, disability is expected to rise because the number of older workers will rise, and older workers are more prone to disability risks than younger workers.

The government has adopted two main policies:

- Reduction of public debt. Between 1983 and 2001, the government debt has decreased by almost 30% of GDP to 52.9% of GDP. Further reduction of government debt will lead to a decrease of interest payments. When the total government debt is removed before ageing has reached its peak, interest payments will decrease by almost 3.5% of GDP.
- Raising the employment rate. The employment rate of the elderly, people aged between 55 and 65, is low in the Netherlands. In 2001, only 35 out of 100 people in this age bracket are still working. The remaining persons are early retired, or receive social security benefits.

To improve the employment rate of the elderly, the government has decided on an action plan with the following elements:

- Working until 65 should be financially attractive.
- Involuntary early retirement (unemployment or disability) should be prevented.

- Voluntary early retirement must also be possible in the future, but the costs should be born by the individual and not by the government, or by the other workers in a company or branch.

- Re-integration in the labour market should be stimulated.

One of the important actions is the ending of preferential fiscal treatment of early-retirement schemes, which are still financed on a pay-as-you-go basis. By 2022, all these schemes should be completely changed into capital funded schemes. Only premiums for capital funded early-retirement schemes will be deductible from taxation. Due to the capital funded character of the new schemes, an actuarially neutral trade-off between the level of pension benefits and the extending of working life will be introduced.

Changes in real rates of interest

Between 1995 and 1999, the real returns of the Dutch pension funds were on average more than 10% every year. This caused lower pension premiums for employees and employers. Compared to the seventies, the pension premiums have fallen impressively.

However, during the last two years, the real returns of Dutch pension funds were much lower. In 2001 these returns were even negative. At the same time, defined benefit schemes that are based on final salary were confronted with high wage increases.

As result of these developments, the pension premiums rose in 2002, and a further rise is expected in 2003. After the fall of the share prices on the stock markets since 11 September, none of the Dutch pension funds encountered direct financial problems. The Pension and Insurance Supervisory Authority noticed, however, that reserves of some pension funds were getting close to the necessary actuarial provisions. Despite these developments, more than 97% of the pension indexation commitments were fulfilled in 2002.

The social partners are primarily responsible for the supplementary pensions. They have to prepare themselves for the possibility that in the next couple of years, the real returns will be lower than in the nineties. This means that:

- Pension premiums can rise further.

- Wage increases should be moderate; these increases have effects on indexation in pension schemes and on back-service costs in final salary schemes.

- Indexation should be kept conditionally on the financial situation of the pension funds.

- Pension schemes could be changed from final to average salary schemes.

It can be expected that the next Dutch government will meet with social partners in September to discuss these developments.

Reform of the Dutch pension system?

The Dutch government does not want to change the Dutch pension system fundamentally:

- The AOW first pillar pension will also in the future remain a basic pension, which is linked to the statutory minimum wage and is not means tested.

- The second pillar will also in the future be the responsibility of social partners with limited government interference. The government will also in future guarantee these occupational pensions, by demanding that these pensions should be fully funded.

To keep the Dutch pension system financially and socially sustainable, however, government action is needed:

- Government debt will be reduced. A large part of this reduction will be put in the AOW saving fund, to be earmarked for future spending on AOW pensions.

- The AOW premiums that are paid by persons below 65 year of age are maximised. A further rise in the costs of the AOW will be financed by taxes. In this way, pensioners will also, indirectly, finance the AOW.

- The government will take measures to raise the employment rate of people in the age-bracket 55 to 65 years. A very important measure is the abolition of the preferential fiscal treatment of pay-as-you-go early retirement schemes.

- The government will consult social partners on possible financial consequences of low real interest, and convince them to take the necessary steps to keep the system sustainable.

There is no doubt that the pension policy will continue to be high on the agenda of the government.

PART III

THE WELL-BEING OF OLDER PEOPLE AND THE DISTRIBUTIONAL CONSEQUENCES OF PENSION REFORM

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Chapter 12

RETIREMENT INCOMES AND ECONOMIC WELL-BEING IN CENTRAL AND EASTERN EUROPE

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Pension system reform in countries in transition

Introduction

In recent years, a number of countries in transition have introduced fundamental changes in their social protection systems, and in particular, as regards their pension provision. The main aim was to ensure the sustainability of the pension provision by reducing the role of the public pension system, and placing a greater emphasis on private provision. In other words, a much larger role was attributed to the second pillar, either in the form of mandatory fully funded and privately managed pension funds, or in the form of voluntary collective pension schemes. Pension reform also involved considerable changes in the first pillar: eligibility conditions have been tightened, and a closer link between contributions paid and benefits received has been established. All the countries which undertook pension reforms moved in this direction; they differ mainly in the role allocated to the second pillar, and in the closeness of the links between contributions and pension benefits.

The role of the second pillar

What role was allocated to the second pillar? A number of countries have opted for mandatory fully funded pension schemes: these are Bulgaria, Croatia, Estonia, Hungary, Latvia and Poland. The implementation of second pillar schemes varies considerably, and Hungary and Poland are undoubtedly the most advanced in implementation, as they now have some years of practical experience of operating such schemes.

Other countries, such as the Czech Republic, Lithuania, Romania, the Slovak Republic and Slovenia, have opted for a "soft" approach, for various reasons. The original reform proposal for pension reform in Slovenia included a mandatory fully funded pillar but, because of strong opposition from the trade unions, the proposal had to be abandoned and (voluntary) collective pension schemes were introduced instead. Romania had gone even further, and backed away from a mandatory scheme at the last moment, prior to its formal introduction. Of course, it can be asked how useful it is to define such schemes as either mandatory or non-mandatory, implying clear distinctions which may not always exist; as is well known, voluntary pension schemes can eventually evolve in such a way as to cover the whole working population.

It is tempting to observe that countries with first-hand experience of a simple form of financial intermediation, *i.e.* pyramid schemes, have approached pension reform with a high degree of suspicion

and circumspection. These pyramid schemes wiped out considerable private savings in Serbia,[1] Romania and Albania; their collapse in Albania provoked widespread revolt. This might explain the reticence in introducing a mandatory fully funded pillar in Romania, as well as the failure to introduce fully funded schemes in Albania. Palacios (2000, p. 26) aptly summarised Albania's experience: "Given the general inadequacy of financial sector regulation which led to the collapse of various pyramid schemes in 1997, it may be fortunate that private pension schemes did not proliferate after passage of the law. The Albanian situation may hold lessons for some of the poorer former Soviet Union countries in the process of developing private pension legislation. Clearly, legislation and regulations cannot be effective unless accounting, reporting, investment and other rules are enforced."

The linkage between contributions and pension benefits

How far did pension reforms go in the direction of tightening the link between contributions and benefits within the first, public, pillar? Some countries went "all the way", and reformed their public pillar in such a way that the public pension system in effect resembles a defined contribution system (DC). In other words, the public system "imitates" the private pension system, by creating notional individual accounts (NDC), and imputing a rate of return set, not by the market, but by government. Such a system leaves no room for redistribution between groups of insured persons, nor for redistribution between generations. Latvia and Poland have introduced NDC schemes. Other countries, however, have also moved toward DC systems, but in a more gradual way: by tightening entry conditions, increasing the contribution period relevant for calculating the pension assessment base, decreasing accrual rates, and thus decreasing the implicit rate of return within the first pillar.

It is clear that pension reforms have endeavoured to decrease the redistributive role of the pension system. The logic behind this move is that by establishing a clear link between contributions and benefits, the negative effects of pension schemes on the functioning of labour markets are minimised. In other words, it is hoped that a tight link between contributions and benefits, and respect for actuarial fairness, will reduce pressures for early retirement and for switching from the formal sector to the informal, non-taxed, sector. It is also hoped that it will improve contribution collection, as well as enhance the perception of pension contributions to the first and second pillar, as a form of deferred remuneration, and not simply as a tax. As Marin *et al*. (2001, p. 32), in their analysis of Hungary, put it: "Eliminating any redistribution even within the social security pension pillar was motivated mainly by an attempt to restore the credibility of the insurance principle within the pay-as-you-go (PAYG) system, as its overt violation was believed to have caused the informalisation of the economy, a decline in the covered wage bill (*i.e.* the tax base) and, thereby, the disastrous pension deficits in the first place".

Other goals of the pension reform

Pension reforms were mostly concerned with the broader issues, *i.e.* ensuring the long-term sustainability of pension systems, minimising their negative effects on the functioning of the labour market and, through development of the second pillar, increasing national private savings, stimulating the capital markets, and, eventually, promoting growth. It is not far from the truth to say that the economic well-being of the elderly was not the prime concern of the reforms. This, of course, does not mean that reform proposals completely neglected this issue. Typically, the new replacement rates were significantly lower. Moreover, countries that introduced the mandatory fully funded second pillar set

1. It may be observed in passing that pyramid schemes in Serbia were analysed by Stanovnik and Kuzmin (1993) in the article "The Secrets of Grand Maitres". The half-mocking predictions in this newspaper article were validated, including the exact escape route of the founder of the largest pyramid scheme!

the contribution rate for the second pillar so as to achieve a target replacement rate, stemming from both pillars. What must be taken into account, however, is that the "stylised" computed replacement rates are one matter, and actual replacement rates another. In addition, the transition period from the old to the new, reformed, pension system is in most cases quite long, and the mix between the elements of the old and the new systems can result in outcomes which are difficult to predict in advance. Last, but not least, the great influence that macroeconomic conditions have on the pension system must not be forgotten: a weak labour market and a high unemployment rate will exert strong and continuing pressure for early retirement. Despite the fact that early retirement will be heavily penalised, this might not prove to be a sufficient incentive for a more extended participation in the labour market.

In discussing the goals of pension reform, social issues cannot be bypassed. While it is true that even in Bismarckian systems, the main aim is income replacement and not poverty reduction, it has to be acknowledged that a pension reform cannot be said to be successful if it increases the number of retired persons living in poverty. Therefore, there is a clear need to analyse the economic well-being of the elderly, in order to ascertain their relative income position, particularly in comparison with other potentially vulnerable groups, such as the unemployed and children.

Macroeconomic developments and retirement incomes in transition countries during the nineties

Macroeconomic developments and the tax base

This analysis will be confined to Central European countries: the Czech Republic, Croatia, Hungary, Poland, the Slovak Republic and Slovenia; the Baltic States: Lithuania, Latvia and Estonia; and two countries of South Eastern Europe: Bulgaria and Romania. Though this group of countries is quite heterogeneous, they do share one common feature: they are in various stages of accession to the European Union. This limitation of the scope of the analysis will facilitate a better focus on the relevant issues.

The basic macroeconomic indicators are well known, and will be described only briefly. Even by the year 2000, the GDP of most countries in this group did not reach the 1989 levels. Only in Poland and Slovenia was output, measured by GDP, considerably greater in 2000 than in 1989; in Hungary and the Slovak Republic, it was barely higher than in 1989. Employment had also decreased, and in 2000, stood at some 70 to 90%of the pre-transition level (1989). Milanović (1998) reports that income inequality increased in almost all countries in transition. As for developments on the pension front, these are also well known, and have been analysed in detail by Fultz and Ruck (2001) and Palacios (2000). The number of pension contributors decreased and the number of pensioners increased, so that the system dependency ratio, *i.e.* the pensioners/contributors ratio, deteriorated, in some countries quite rapidly. Furthermore, the "quality" of the contributors deteriorated, as many turned to self-employment, where under-reporting of income is sizeable. Also, for many employees, the employers did not pay contributions, or delayed paying them.

Bismarckian insurance type pension systems can function well, provided the quality of the group of insured persons (contributors) is satisfactory, *i.e.* that the bulk of insured persons are employees, who regularly pay social security contributions. The functioning of the system becomes difficult when the pool of employees shrinks, and the ranks of the self-employed and farmers increases. These two groups pay relatively small contributions or none at all. As an illustration, Tinios and Markova (2001) report that 50% of all the self-employed in Bulgaria are not insured**.** In Slovenia, which has a well functioning collection mechanism, the self-employed comprised 6.5% of all contributors, but contributed only 3.7% of the revenues of the Institute for Pension and Disability Insurance of Slovenia.

The structural shifts in the labour force and an increasing informalisation of the economy, seen as a flow from the formal sector into the informal sector, caused a reduction in the tax base (the "covered wage bill"). As documented by Palacios (2000, p. 8), the deterioration of the revenue base was particularly severe for low-income countries. A fall in the tax base in turn requires increasing contribution rates to finance pension expenditures; this increase then causes further outflows from the formal sector and a general decrease in its competitiveness. This vicious spiral feeds on its own inner dynamics, until it snaps. In other words, the government intervenes, places a ceiling on contribution rates and/or stabilises pension expenditures.

Faced with the problem of a diminishing tax base for social security contributions, most countries in transition took measures to stabilise or even decrease pension expenditures (measured as a percentage of GDP). This was done in a very pragmatic way, through various forms of indexation, which in effect decreased the real value of pensions. This indexation, mostly performed on an *ad hoc* basis, significantly compressed the distribution of pensions. In other words, governments put a very strong emphasis on the redistribution ("solidarity") principle that was pragmatically applied, not only to existing pensions, but also to new entry pensions. These measures caused serious "construction" damage to Bismarckian systems, which are, in essence, income replacement systems. The various pragmatic approaches to indexation, as practiced by several countries in transition, will be observed.

Indexation and redistribution within the pension system

Margan (2001, p. 7) reports that in Romania from 1990 to 1998, pensions increased only occasionally, and not fully in line with price increases. In 1999, pensions increased by 22%, while inflation was over 50%. Tinios and Markova (2001) state that indexation in Bulgaria in the 1990s was *ad hoc*, which in effect meant that the distribution of pensions became very compressed. This practice stopped in 1998. Augusztinovics *et al*. (2002, p. 30) report for Hungary, that from 1996 onwards, pensions were increased according to the nominal wage index of the previous year; this occurred amidst high inflation, which was around 20% in those years. In the early 1990s, valorisation for entry pensions was omitted, as earnings of the 3-4 years prior to retirement were not valorised, but taken at nominal value. Those who retired in the early and mid-1990s lost heavily. As a result of these measures, pension expenditures in 1998, measured as a percentage of GDP, decreased. Only in 2001, did the indexation rule "stabilise" and the Swiss formula was applied (50% price increase, 50% wage increase). Mácha (2002, p. 84) cites the indexation rule for the Czech Republic. According to the 1995 law, if the overall retail price index rose by more than 5%, the government must increase pensions by at least 70% of this price increase. In 1997/98, the threshold was temporarily increased to 10%; Večerník (2001) reports that this change caused a slight decrease in the replacement rate. In contrast, Slovenia has basically followed the same indexation rule, *i.e.* indexation according to nominal growth of average net wage throughout the 1990s (Stanovnik, 2002). Poland, through the 1991 Revaluation Act, increased the value of pensions relative to wages; in effect, it ironed out the differences between pensions granted in different time periods. The indexation rule was changed to price indexation (instead of wage indexation), effective from 1996. In that year the Sejm (parliament) also passed legislation that allowed for some real growth of pensions, the amount being set out in the annual budget law (Chlon-Dominczak, 2002).

Indexation of pensions, either *ad hoc* or formal, not only prevented real increases in pensions, but also in many countries resulted in a more compressed ("egalitarian") distribution of pensions, as the rate of increase was not proportional, but depended on the pension level. This practice eventually produced a compressed pension distribution. Of course, this was not a common practice; it was an "instinctive" and pragmatic solution to which governments reverted in times of dire economic and social conditions. Though the topic of the distribution of pensioner incomes will be addressed later, some circumstantial evidence is provided here on what might have happened to this distribution. For

Hungary, the Central Statistical Office of Hungary (2000, p. 14) reports that in January 1999, 75% of all pensions fell in a narrow band between HUF 30 and 40 000, the average being HUF 32 900. In Romania, the ratio between the minimum and average old-age pension (based on a full contribution period), was 0.88 in 1995 (Molnar, 2000); this implies a fairly egalitarian distribution of pensions. At the other end of the spectrum, Croatia has a very unequal distribution; in spite of relatively large pension expenditures (as a percentage of GDP), nearly half of all pensioners received HRK 1 000 per month, which is slightly more than half the mean monthly per capita household expenditure (World Bank, 2000*b*: 320). This is doubtless caused by a large number of high pensions granted to war veterans and other military personnel. In Slovenia, the pension distribution has not changed much in the last ten years, and the Gini coefficient for pensions has increased from 0.24 in 1991 to 0.26 in 2000, whereas the Gini coefficient for wages increased from 0.25 to 0.30 in the same time period (Borak and Pfajfar, 2002).

Replacement rates

Countries in transition have practiced various indexation rules, most of which have resulted not only in a real decrease of pensions, but also in a decrease in pensions relative to wages. This means that the net replacement rate, which is defined as the ratio between average (net) pension and average (net) wage has decreased through time, and this seems to be confirmed by data presented in Table 12.1. The table provides the values for the net replacement rate for several countries in central Europe and two countries in South Eastern Europe. Though the replacement rate[2] decreased, there are two exceptions; in Poland, the replacement rate increased, whereas in Slovenia, it remained stable, for the reasons explained above. In Poland, the "ironing out" effect, and the fact that wage indexation up to 1996 quite substantially increased the replacement rate. As for Slovenia, its stubborn clinging to the net wage indexation formula throughout the period could not produce anything but a stable replacement rate.

Though the net replacement rates for the Baltic countries are not presented in Table 12.1, they seem to be low in comparison to Central European countries. Thus, for Estonia, the net replacement rate, taking the average net old-age pension as the numerator, was some 45% in 1999; in Lithuania in 2000, the net replacement rate was about 40%.[3]

Income inequality

In almost all European countries in transition, income inequality increased considerably during the early 1990s; this can be seen from Table 12.2, which shows the values of the Gini coefficients in a pre-transition year and in the 1990s. It can be observed that there were particularly large increases in the Baltic States and in the countries of South Eastern Europe. Following this initial rapid change in the income distribution, it seems that income inequality − as measured by the Gini coefficient − stabilised. In other words, further changes in the Gini coefficient were rather modest. This is, of course, only a general conclusion and is not valid for all countries; for example, in Poland inequality continued to increase, even in the late 1990s.

2. Some authors, for example, Whiteford (1995) and Palacios (2000) are rather critical of using replacement rates, with wages in the denominator. Nevertheless, their use is retained, though the "information content" of such replacement rates must be put in proper perspective.

3. It is quite unfortunate that the World Bank (2000*a*, Annex) provides only tables on gross replacement rates. As most of these countries introduced a personal income tax only in the early 1990s, a comparison of the pre-1990 and mid-1990s gross replacement rates is meaningless. Also not to be forgotten is the fact that most European countries in transition provide special tax treatment for pensions.

Table 12.2 also provides the relevant data on GDP growth, from which it can be observed that most countries experienced negative growth rates in the 1990s. This combination of negative growth rates and increased inequality can result in a large increase in poverty.[4] Of course, any deterioration of the income distribution towards greater inequality would cause an increase in poverty, measured in relative terms. The point is that this combination of a worsening income distribution and negative growth has severe negative social effects, particularly for low-income countries.

Using an absolute measure of poverty, Milanović (1998, pp. 68-69) calculated poverty incidence in a pre-transition year and in the mid-1990s; quite predictably, the poverty headcount increased substantially in most European countries in transition. Among our group of countries, the increases were very high in all the Baltic States, the countries of South Eastern Europe and Poland. In the other Central European countries, the increase in poverty, as measured by the poverty headcount, was modest.

Poverty incidence among pensioners and among the elderly

How have pensioners fared during these major social and economic changes? Milanović has shown, using household survey data for the early and mid-1990s, and − this time − relative poverty measures, that the poverty rate for pensioners was less than the average national poverty rate for most countries included in the analysis (Milanović, 1998, p. 93). Thus, pensioners in Hungary, Poland, Romania and Slovakia had a below average poverty incidence, in Bulgaria slightly above average and in Estonia considerably above average. The income position of pensioners is particularly favourable if this group is compared to another important and potentially vulnerable group – the unemployed. Their poverty rate was much higher than the average: for example, the unemployed in Poland in 1993 had a poverty rate four times the national poverty rate, and in Hungary, (in 1992-93) 2.5 times the national poverty rate.

In analysing poverty among age groups, Milanović (1998, p. 103) has shown that persons of retirement age have a below average poverty rate in Bulgaria, the Czech Republic, Hungary, Latvia and Poland; only in Estonia do persons of retirement age have a poverty incidence slightly above average. Who then are the "losers", *i.e.* what age group has a higher than average poverty rate? His analysis shows that children are a very vulnerable age group, and that their poverty rate is above average in all countries included in the analysis.

Research, based on more recent household surveys, seems to confirm Milanović's conclusion that pensioner households have actually improved their income position during the transition.

A World Bank team analysed poverty and inequality in the transition countries of Europe and Central Asia, and its report *MakingTransition Work for Everyone* was published in 2000 (World Bank, 2000*b*). Their empirical analysis was unfortunately confined only to the most recent year, and it is thus impossible to analyse the poverty dynamics within a given country. Nevertheless, the analysis is extremely valuable, as it is based on a common methodology. It also uses several different equivalence scales and different relative measures of poverty. This approach provides the opportunity to test the robustness of the results, *i.e.* the sensitivity of poverty rates for various groups, with regard to equivalence scales and relative poverty measures chosen.

Table 12.3 presents the relative poverty risk index for households with retired heads. A poverty risk index of 1 presents the average national poverty rate. The value of this index is shown for two

4. As Milanović (1998, p. 85) coined it: "The descent into poverty is the product of two forces: lower income and greater income inequality".

different equivalence scales, one using the value of theta=0.75, and the other using the value of theta=0.5, which approximately corresponds to the modified OECD equivalence scale. The value of theta=1 implies that there are no economies of scale in consumption, *i.e.* that household income/number of household members is a satisfactory indicator of economic well-being of household members. The relative poverty line is set at 50% of median equivalent household income.

As seen from Table 12.3, different equivalence scales produce quite different results. It is tempting to – somewhat cynically – observe that it is not surprising that the World Bank team in the main text of the study analyses the results based on theta=0.75, as this equivalence scale shows the retired to be in a favourable income position. In actual fact, there are strong arguments for preferring this equivalence scale. Namely, econometric work seems to suggest that flatter scales are not acceptable for transition countries, as large economies of scale in consumption in these countries do not exist. For example, Szulc (1995) calculated econometric equivalence scales for Poland and obtained results close to the standard OECD scale. Similarly, Hancock and Pudney (1997) found the OECD scale acceptable for Hungary. An equivalence scale using theta=0.5 is perhaps suitable only for the Czech Republic and Slovenia, the high-income countries in transition.

To sum up, the analysis of poverty based on theta=0.75 is to be preferred. Thus from Table 12.3 (column 1), it can be observed that in the Czech Republic, Hungary and Poland, households with retired heads have a much lower poverty incidence than the national average. Households with retired heads in Latvia and Romania also have a lower poverty incidence than the national average. On the other side of the divide, in Bulgaria, Croatia, Estonia and Lithuania, households with retired heads have an above average poverty incidence; with Croatia and Lithuania being extreme cases.

Other studies are also in broad agreement with those quoted above. Thus, Schrooten, Smeeding and Wagner (1998) used the Luxembourg Income Study (LIS) database, *i.e.* the household income microdata for the Czech Republic (1988; 1992), Hungary (1987; 1992; 1994) and Poland (1986; 1990, 1992; 1995). They compared the median equivalent income of a given group (elderly over 60) to the national median equivalent income. This indicator shows a continuous increase in all three countries, as seen from Table 12.4.

The World Bank study states that "Pension systems have played an important role in protecting beneficiaries against poverty…in most countries the incidence of poverty for households headed by pensioners is much lower than for other groups, such as the unemployed or working poor. In addition, the elderly have a lower relative risk of poverty than other demographic groups have" (World Bank, 2000*b,* p. 320). These are perhaps somewhat exaggerated claims, as the elderly do not have the lowest relative risk of poverty among all demographic groups. It is true that they have a lower relative poverty risk than children. Also, the study rightfully mentions a type of elderly household that has a high poverty incidence in all transition countries − single elderly women.

An analysis of the income position of the elderly in transition countries, based on micro data

Generally speaking, comparative country studies which provide an in-depth analysis of the income position of pensioners and the elderly in transition countries are rare. In principle, such studies ought to be performed by country experts, cognizant of the institutional and macroeconomic set-up, as well as possessing thorough experience with the datasets that are used in the analysis. Also, in order to have meaningful cross-country comparisons, a uniform methodology must be used. Unfortunately, the use of a common methodology and common set of definitions is not without problems. The principle "one size fits all" is not the ideal solution for, say, an equivalence scale; it is, however, necessary and operationally efficient. As for the definition of income, questions arise with regard to the inclusion of intra-family transfers and consumption-in-kind; both of these income items are important in countries

in transition. One must also bear in mind that the quality of household surveys in countries in transition varies considerably. Some of these countries experienced large changes in survey design; for example, in Hungary, the household budget surveys (HBS) of the late 1980s are quite different from the household panels introduced in the early 1990s.

All these problems did not prevent researchers, particularly researchers from the World Bank, the OECD and researchers using the LIS datasets, from performing various analyses based on household income or expenditure surveys in countries in transition; some of their research findings have already been presented here. It can be observed that there are few comparative and in-depth studies of the income position of the elderly in transition countries. This is not true for developed OECD member countries, and there have been a considerable number of studies devoted to this topic, the most recent one published in a book edited by Disney and Johnson in 2001 (*Pension Systems and Retirement Incomes Across OECD Countries).*

Among studies devoted exclusively to the analysis of transition countries, is that by Schrooten, Smeeding and Wagner (1998), which analyses the income position of the elderly in the Czech Republic, Hungary, Poland and the Slovak Republic. Another study, which analysed their income position and economic well-being in five countries, among which were three countries in transition, was published in a book edited by Tine Stanovnik, Nada Stropnik and Christopher Prinz (*Economic Well-being of the Elderly: A Comparison Across Five European Countries*, (2001). In this research, financed through the Phare-ACE programme, country experts assumed responsibility for the national studies, performed under a common methodology and with common definitions of relevant economic and social categories. Thus, Adam Szulc prepared the study on Poland, Zsolt Spéder on Hungary, Christopher Prinz on Austria, Carl Emmerson, Paul Johnson and Gary Stears on the United Kingdom and Tine Stanovnik and Nada Stropnik on Slovenia. For the methodological issues and definitions employed, the inquiring reader is referred to the aforementioned book. The main findings are presented, however; these are generally in agreement with the studies presented above, though the research goes into somewhat greater detail in the analysis of the survey data.

The homogenisation of pensioners

There are a number of common features shared by the three countries in transition that remain in the comparative analysis. Thus, pensioner households − households with at least one pensioner and no active member (no employed, self-employed or unemployed), have experienced quite large changes in the structure of their household income. The share of earnings has decreased in these households during the transition years in all three countries: Hungary, Poland and Slovenia. This has doubtlessly been caused by diminishing earning opportunities.[5] Another homogenisation has been taking place: an increasing number of pensioners live in pensioner households. Thus in Poland, in 1996, 53% of all pensioners lived in pensioner households; the corresponding figure for Hungary in 1996 is 71%, and for Slovenia in 1993, 59%. Of course, this "homogenisation" is still lower that that in developed market economies; for example, in the United Kingdom, a full 80% of all pensioners live in pensioner households. Table 12.5 shows the share of various types of pensioner households, as a percentage of all households.

Among pensioner household types, the single female household, and the couple household, are the most prevalent, their shares being about equal in all three countries. For example, in Poland the

5 This phenomenon was also present in other countries in transition. Thus, Puur (1999) reports for Estonia, that a large drop in earnings dramatically reduced the incomes of younger pensioners in the mid-1990s. Széman (1996) reports for Hungary that, from 1990, pensioners were no longer able to find work, and that by 1992, only 9% of all pensioners were working.

share of single female pensioner households as a percentage of all households is 8.1% (in 1996), whereas the comparable figure for couple pensioner households is 8.6%. The prevalence of these two types of pensioner households is also high and their shares are about the same in the two "non-transition" countries – Austria and the United Kingdom.

The improving income position of pensioners and pensioner households

Table 12.6 shows that the share of pensioners in the bottom three deciles has decreased considerably in all three countries. In line with expectations, this relative improvement in the lower part of the income distribution levels has not been matched by corresponding increases in the upper parts. In other words, an increasing share of the pensioner population is now situated in the middle of the income distribution.

The distribution of pensioners by income deciles is also given in Figure 12.1, which shows that pensioners are under-represented in the first decile, as well as in the top deciles; the shapes of these distributions are similar to the distributions for developed OECD member countries, as seen in Whitehouse (2000).

Of course, not only pensioners but also pensioner households experienced a remarkable improvement in their income position, as shown in Table 12.7. Here it can be seen that a couple pensioner household is in the best income position among pensioner households. "Other" pensioner households are actually a heterogeneous and "ill-defined" residual category; these are non-couple households with at least two members, and, most probably, only one receiving pension income. Single male pensioner households are a small group. As for single female pensioner households, these are still over-represented in the lower income deciles in Hungary and Slovenia. It can be said that, in spite of the general improvement in the income position of all types of pensioner households, the income position of a very sizeable group − the single female pensioner household − is still precarious.

The improving income position of the elderly

Table 12.8 presents the proportion of persons in the bottom three deciles for three age groups. This table shows that, as a rule, the income position of a group deteriorates with increasing age. The only exception is Poland, where in 1987, the share of persons aged 80 and above situated in the bottom three deciles was smaller than the share of persons in the age group 70-79 situated in the same deciles. Thus, in 1987, 36.4% of all persons in the age group 70-79 were situated in the bottom three deciles, but only 29.3% of all persons aged 80 and over. This phenomenon of decreasing incomes in the elderly age groups can be partly explained by the fact that younger cohorts tend to be richer than older cohorts. There are of course country-specific variations to this general phenomenon.

Also, a shift in the gender structure is an important factor in explaining the decreasing income in the higher age groups. Thus, the proportion of women above age 70 is much higher than the proportion of men, and women typically have smaller pension entitlements. In Slovenia, the very large share of elderly persons in the bottom three deciles can be explained by the large number of elderly dependants (mostly women), and the fact that many farmers receive quite low pensions.[6]

6. These pensions could almost be labelled as non-contributory benefits, since the contributions that farmers pay are negligible, in proportion to the benefits (albeit small) they receive. The large number of elderly dependants, implied by this analysis, surfaced in the past two years, when a non-contributory national pension, an "innovation" introduced by the pension reform, was being disbursed to elderly citizens, who did not have their own income sources.

It can be noted that the income position of the elderly improved markedly, with strong gains for the elderly in Hungary, somewhat smaller gains in Poland and relatively modest gains for the elderly in Slovenia, particularly for the age groups 70-79 and 80+. The 80+ group gained only 2.9 percentage points, *i.e.* in 1983 55.6% of all persons aged 80 and above were situated in the bottom three deciles, and in 1993 this decreased to 52.7%.

Gender and income position

Gender differences in the income distribution of the elderly population reproduce the gender differentials in educational attainment, in labour force participation and in income from work. Essentially, gender differences indicate the extent to which differences in the distribution of paid and unpaid work during adult life translate into income differences in older age (Table 12.9).

Looking at the same indicator as before – the proportion of persons (or households) in the bottom 30% of all persons (or households) – three different groups are compared by pairs: a) single male and. single female pensioner household, b) male and female pensioners, and c) men and women aged 60 and over. The first comparison is one of a relatively small group, at least as far as men are concerned. This is the most direct comparison of gender differences, since household incomes considered here only consist of a male or of a female (pension) income. The second comparison (b) includes all persons aged over 50 declaring themselves to be pensioners, *i.e.* drawing an old-age, survivor or disability pension. Here income does not take own pension income in account, as all the surveys did not have individualised data on income sources, and income sources were at the level of households. Thus, a pensioner is taken with his(her) equivalised income. The third comparison (c) looks at all the elderly aged 60 and over. Similarly to the second comparison, the income of the partner (and potentially other members of the households) is also taken into account, and equivalised incomes are compared. The main difference with the second comparison is that persons without income or pension entitlement (such as housewives) are now explicitly taken into account. Higher gender differences in this comparison as compared to comparison (b) would indicate that a high proportion of elderly women are totally dependent on the spouse's income.

Obviously, all six groups (single female pensioner households, single male pensioner households, etc.) have improved their relative income position, though gender differences have remained. These gender differences are as would be expected, *i.e.* the income position of any given female group is usually relatively worse off than the equivalent male group, though there are certain exceptions to this rule. Single female pensioners are in the worst position in all three countries, because they depend entirely on their own pension income. The income position of female pensioners is better than the income position of single female pensioner households. For example, in Hungary in 1996, 46% of all single female households were situated in the bottom three deciles, whereas the corresponding figure for female pensioners is only 23%. This of course implies that sharing the (higher) income of the male partner improves the income position of female pensioners. One would expect that the gender difference would show the male population (individuals or households) to be in a consistently better income position than the corresponding female population. This is, in fact, the case, except for the gender difference for pensioners in Slovenia. Bearing in mind that taking the equivalised (and not personal) income, the fact that female pensioners in Slovenia were in a better position than male pensioners can be explained. Namely, male pensioners, particularly in 1983, shared their income with spouses, who were largely without their own incomes. Female pensioners are in a better position, as they do not live with dependent males. Predictably, this situation, *i.e.* the "unexpected" gender difference in Slovenia, has changed significantly in the direction of the "expected" difference in 1993, as the number of elderly women without any income of their own has decreased.

In Poland and Hungary, there is only a slight difference between female pensioners and all women aged 60 and over, though the first group is always slightly better off. An explanation for this small difference is the relatively low proportion of women without pension entitlements in these countries. Slovenia is the only country where women aged 60 and over are in a significantly less advantaged position than female pensioners. The explanation is the same as in the preceding paragraph: a large proportion of elderly women (40% in 1983 and 31% in 1993) were without any pension entitlements.

Poverty and inequality

Poverty is defined in relative terms, *i.e.* as a given percentage of the median equivalent household income. In this study, various poverty lines were taken, and poverty incidence was computed; the results are presented, using the 50% poverty line.

The results presented in Table 12.10 are hardly surprising, as low poverty incidence could be deduced from the analysis. It cannot fail to be noted that there is a very low poverty incidence for pensioners, pensioners in pensioner households and persons aged 60 and over in Hungary and Poland. Poverty rates for these three groups are well below the national average. Slovenia offers a somewhat different picture. Here, the poverty rate in 1993 for pensioners was just slightly below the national average, whereas that for pensioners in pensioner households, and for persons aged 60 and over, was above the national average; for the latter group quite considerably above. Nevertheless, even for Slovenia, the poverty rates for the three groups decreased between 1983 and 1993.

Also briefly presented was an income inequality measure – the Gini coefficient. The Gini coefficient for the total population (taking individuals with their household equivalent income) has increased considerably in Hungary, Poland and Slovenia. Part of the explanation is that the incomes of certain groups, mainly entrepreneurs and the self-employed, have increased considerably in the period of transition (Table 2.11).

The ranking of subgroups with regard to the Gini coefficient is similar to the ranking based on poverty incidence. Thus, the computed Gini coefficient for pensioners is consistently lower than that for the whole population. In full agreement with expectations, the Gini coefficient for pensioners in pensioner households is lower than that for all pensioners: income in pensioner households is more homogeneous and consists mostly of pensions, which are more equally distributed than other income sources. The Gini coefficient for persons aged 60 and over is in Poland and Slovenia greatest among the three subgroups; this again is in line with the results based on the poverty analysis.

Concluding remarks

Is there a "bottom line" in the assessment of retirement incomes and the economic well-being of the elderly population in countries in transition? Most studies suggest that there has been an overall improvement in the relative income position of pensioners and the elderly during the transition years. This is just a broad conclusion, and each country has a story of its own.

Of course, the relative income position is not an immutable category. Adam Szulc provided a quite thoughtful title to his contribution to the book *Economic Well-being of the Elderly: A Comparison Across Five Countries* (Stranovnik *et al*., 2000). It reads: "Poland: Transition Gainers With an Uncertain Future". And indeed, the large improvements in the relative income position of pensioners and the elderly are, in some cases (such as Poland), quite astonishing, but they are not necessarily permanent.

In view of the far-reaching pension reforms that have been enacted, and in many countries already implemented, there is a clear need for continuing analysis of the relative income position and economic well-being of the elderly. Hopefully, this will also give the necessary stimulus for carefully planned comparative studies, particularly for those countries for which reliable microdata exist. Such research will not only provide a useful "monitoring" function of pension reforms, but also provide an essential element for social policy decision-making.

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Table 12.1. Net replacement rates (average net pension/average net wage) for several Central and South Eastern European countries

		In per cent
South Eastern Europe		
Bulgaria	(2000)	appr. 50
Romania	(1990)	47
	(1996)	39
Central Europe		
Poland	(1989)	53.3
	(1996)	72.5
Czech Republic	(1989)	63.8
	(2000)	57.2
Hungary	(1990)	66.2
	(1996)	58.9
Slovak Republic	(1989)	58.4
	(1996)	54.0
Slovenia	(1991)	66.6
	(2000)	68.7

Source. For Bulgaria: Tinios and Markova (2001), for Romania, Molnar (2000), for Hungary: Spéder (2000), for Poland and the Slovak Republic: Schrooten *et al.* (1998), for the Czech Republic: Mácha (2002), for Slovenia: 2001 Annual Report of the Institute for Pension and Disability Insurance.

Table 12.2. Changes in inequality and real GDP during the transition

	Gini coefficient			Level of real GDP in 2000 (1989=100)
	Pre-transition	Early 1990s	Late 1990s	
South Eastern Europe				
Bulgaria	0.23 (89)	0.34 (93)	0.41 (95)	71
Romania	0.23 (89)	0.29 (94)	0.30 (98)	77
Central Europe				
Poland	0.26 (87)	0.28 (93)	0.32 (98)	127
Czech Republic	0.19 (88)	0.27 (93)	0.25 (96)	98
Hungary	0.21 (87)	0.23 (93)	0.25 (97)	104
Slovak Republic	0.20 (88)	0.19 (93)	–	103
Slovenia	0.22 (87)	0.25 (93)	0.25 (97/98)	114
Croatia	-	-	0.35 (98)	80
Baltics				
Estonia	0.23 (88)	0.35 (93)	0.37 (98)	83
Latvia	0.23 (88)	0.31 (95)	0.32 (97/98)	64
Lithuania	0.23 (88)	0.37 (94)	0.34 (99)	65

Note: For most countries, the income concept in column 2 is disposable income; in column 1, it is gross income. Personal income taxes in 1987-88 were small, and so is the difference between disposable and gross income. For columns 1 and 2, income includes consumption-in-kind, except for Hungary and Lithuania (in column 2). For column 3, income does not include consumption-in-kind, except for Hungary and Latvia. For column 3, taxes are included for Hungary, Latvia and Estonia.

The Gini coefficient is computed on the basis of household income per household member.

Source: For columns 1 and 2: Milanović (1998:41); for column 3: World Bank (2000*b*, Appendix D); for column 4: EBRD (2001, Annex 3.1).

Table 12.3. Relative poverty risk of households with retired heads (poverty line=50% of median equivalent household income, two different equivalence scales)

		theta=0.75	theta=0.50
South Eastern Europe			
Bulgaria	(1995)	113	126
Romania	(1998)	74	107
Central Europe			
Poland	(1998)	56	82
Czech Republic	(1996)	61	150
Hungary	(1997)	52	127
Slovak Republic		–	–
Slovenia		–	–
Croatia	(1998)	138	178
Baltics			
Estonia	(1998)	116	156
Latvia	(1997/98)	92	119
Lithuania	(1999)	124	175

Source: World Bank (2000*b*, appendix D).

Table 12.4. Ratio of group median equivalent income to national median equivalent income (group: elderly over 60)

Poland	1986	0.77
	1990	0.75
	1992	0.94
	1995	1.04
Czech Republic	1988	0.72
	1992	0.85
Hungary	1987	0.81
	1992	0.85
	1994	0.85

Note: Equivalence scale used: first adult=1, other adults=0.66, children=0.33.

Source: Schrooten, Smeeding and Wagner (1998, Table 10).

Table 12.5. Share of pensioner households in all households

	% of pensioner households in all households				
	Single male	Single female	Couple	Other	All pensioner households
Hungary (1996)	3.1	12.7	13.7	6.2	35.7
Poland (1996)	1.5	8.1	8.6	4.7	23.0
Slovenia (1993)	2.1	9.9	9.4	4.8	26.2

Note: A "couple pensioner household" means that at least one member of the couple is a pensioner and that neither is employed, self-employed or unemployed.

Source: Stanovnik, Stropnik and Prinz (2000).

Table 12.6. Share of pensioners

A. In bottom three income deciles

	Share of pensioners (%)		Difference (in percentage points)
	mid-1980s	mid-1990s	
Hungary	40.7	20.7	-20.0
Poland	28.6	16.6	-12.0
Slovenia	38.7	31.4	-7.3

B. In top three income deciles

	Share of pensioners (%)		Difference (in percentage points)
	mid-1980s	mid-1990s	
Hungary	20.9	23.8	+2.9
Poland	27.6	36.7	+9.1
Slovenia	23.7	26.9	+3.2

Note: Persons are ranked by their equivalent household income. The equivalence scale is (1, 0.7, 0.5) *i.e.* the OECD equivalence scale. For Hungary the relevant years are 1987 and 1996; for Poland, 1987 and 1996; for Slovenia 1983 and 1993.
Source: Stanovnik, Stropnik and Prinz (2000).

Table 12.7. Share of pensioner households in the bottom three income deciles, by pensioner household type

	Pensioner household type				
	Single male	Single female	Couple	Other	All pensioner households
1980s					
Hungary (1987)	50.2	69.7	45.7	61.0	57.8
Poland (1987	30.8	50.5	22.9	45.5	41.8
Slovenia (1983)	(50.8)	55.5	46.6	61.7	52.8
1990s					
Hungary (1996)	(10.9)	45.9	14.4	60.0	33.3
Poland (1996)	20.0	24.8	8.7	42.6	22.0
Slovenia (1993)	(36.2)	42.8	28.0	54.2	39.0

Note: Brackets denote small sample size.
Source: Stanovnik, Stropnik and Prinz (2000).

Table 12.8. Share of persons in the bottom three income deciles, by age group

	Age group		
	60-69	70-79	80+
1980s			
Hungary (1987)	36.4	56.4	58.4
Poland (1987)	28.1	36.4	29.3
Slovenia (1983)	46.0	52.7	55.6
1990s			
Hungary (1996)	17.4	20.4	28.4
Poland (1996)	18.5	18.8	19.0
Slovenia (1993)	37.4	48.7	52.7

Source: Stanovnik, Stropnik and Prinz (2000).

Table 12.9. Gender differences among pensioners and the elderly: shares in the bottom three income deciles (percentage)

	Single pensioner households		
	Single female	Single male	Gender difference
Hungary (1987)	74	54	20
(1996)	46	11	35
Poland (1987)	51	32	18
(1996)	25	20	5
Slovenia (1983)	55	51	4
(1993)	43	36	6
	Pensioners		
	Female pensioners	Male pensioners	Gender difference
Hungary (1987)	43	40	3
(1996)	23	17	6
Poland (1987)	24	21	4
(1996)	17	16	1
Slovenia (1983)	34	44	-10
(1993)	31	32	-1
	Persons aged 60 and over		
	Women 60+	Men 60+	Gender difference
Hungary (1987)	52	43	9
(1996)	25	15	10
Poland (1987)	33	27	6
(1996)	19	18	1
Slovenia (1983)	50	48	2
(1993)	45	39	6

Source: Stanovnik, Stropnik and Prinz (2000).

Table 12.10. Poverty incidence (percentage of persons) based on the 50% median household equivalent income

Household	Hungary	Poland	Slovenia
All persons	3.9	11.4	7.3
	8.3	**8.4**	**7.1**
Pensioners	5.1	8.7	9.2
	2.3	**2.7**	**6.7**
Pensioners in pensioner household	8.3	10.3	10.7
	2.2	**1.1**	**7.3**
Persons aged 60 and over	7.0	97	15.8
	2.0	**3.1**	**12.6**

Note: Data in first rows refer to the 1980s, and data in second rows (bold type) refer to the 1990s. Hungary: 1987 and 1996, Poland: 1987 and 1996, Slovenia: 1983 and 1993.

Source: Stanovnik, Stropnik and Prinz (2000).

Table 12.11. The Gini coefficient for the population and three population subgroups

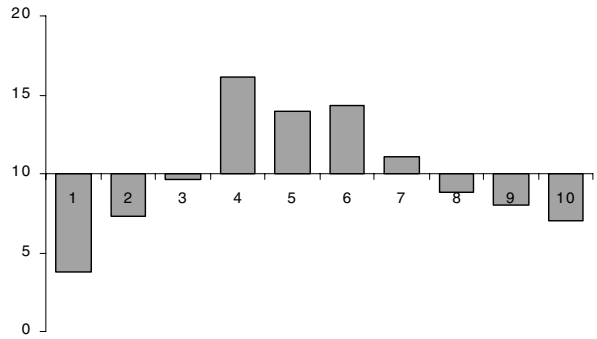
	Hungary	Poland	Slovenia
All persons	0.228	0.278	0.237
	0.286	**0.309**	**0.275**
Pensioners	0.217	0.255	0.242
	0.219	**0.249**	**0.241**
Pensioners in pensioner household		0.230	0.236
		0.218	**0.241**
Persons aged 60 and over	0.220	0.251	0.265
	0.206	**0.260**	**0.263**

Note: Data in first rows refer to the 1980s, and data in second rows (bold type) refer to the 1990s. Hungary: 1987 and 1996, Poland: 1987 and 1996, Slovenia: 1983 and 1993.

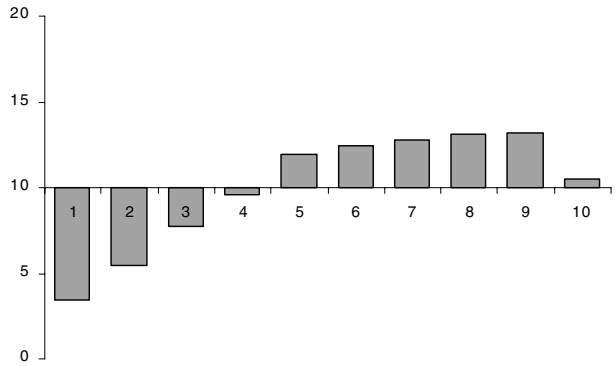
Source: Stanovnik, Stropnik and Prinz (2000).

Figure 12.1. Pensioners by income deciles (vertical distribution)

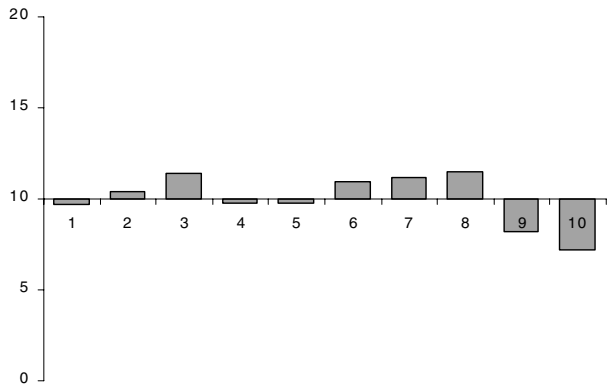
Hungary (1996)



Poland (1996)



Slovenia (1993)



Note: Persons are included with their equivalent household income. The equivalence scale is (1, 0.7, 0.5) i.e. the OECD equivalence scale.

Source: Stanovnik, Stropnik and Prinz (2000).

Chapter 13

PENSIONER LIVING STANDARDS IN THE RUSSIAN FEDERATION

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Introduction

The objective of this chapter is to analyse the different aspects and dimensions of the living standards of different categories of pensioners in the Russian Federation, and to consider the causes and factors underlying these differences. The problems of the Russian pension system are not given specific attention, although these issues are also covered.

Given this main objective, the focus will be on the following issues:

- The current ageing of the population in the Russian Federation and some characteristics of the system of pension security.
- The legislative basis for defining pensioner living standards.
- The dynamics of some key indicators of pensioner living standards and of the pension system during transition (starting from 1992).
- The factors influencing pensioner living standards and the differences in living standards of different categories of pensioners.
- A comparative analysis of the living standards of different groups of pensioners with the living standards of other groups in the population, using as a uniform criteria the amount needed for minimum subsistence by different socio–demographic groups in the population.
- Social policy measures and instruments aimed at improving pensioner living standards.

The information in the chapter is based on the official statistics of the State Committee on Statistics of the Russian Federation (Goskomstat) and on reports prepared by the Ministry of Labour and Social Development of the Russian Federation. These include: legislative acts, official documents, and laws of the Russian Federation; information from international organisations dealing with pensioner living standards and pension security studies; some findings of research on pensioner living standards and the pension system carried out by leading Russian scientific institutions; findings from

the author's own researches (Razumov, 2001). Certain data, facts, and opinions presented in the report are not final and may be further updated.

The current ageing situation and some characteristics of the pension system

The age structure of the Russian population is characterised by gradual growth in the share of persons above working age, which is a typical feature of the worldwide population ageing process (including most transition and OECD member countries). Under Russian law, the officially fixed, normal retirement age is 60 for men and 55 for women, which is quite low by international standards. Accordingly, woman over 55 and men over 60 are often considered to be "elderly" people.

Just over 30 million elderly people (above working age) resided in the Russian Federation in 2000, constituting 20.7% of the total population. The share of senior citizens in the country's population is expected to rise further in the long term. The age structure of Russia's population is visibly tilted towards women, particularly in the oldest age groups. Men account for 34.5% of the country's citizens aged 60 and over, and women for 65.4%. The disproportion between the male and female shares of the Russian population increases with age. The proportion of women rises to 77.8% of those aged 85 years or older.

Senior citizens constitute one of the largest socio-demographic population groups in the country, and they often experience problems such as poor health, limited financial resources, and loneliness. Single old women are really the specific social problem. Many woman of advanced age live alone for various reasons (spouse's death, divorce or separation). Even though a policy aimed at safeguarding the wellbeing of senior citizens has been followed during the past decade, elderly women remain among the population groups least provided for.

Retirement has a drastic effect on an elderly person's living conditions and lifestyle, and affects the nature, forms and level of that person's activity in many areas. The number of pensioners registered at the end of 2000, in the offices of social protection of the population, amounted to 38.4 million persons, compared to 35.3 million in 1992 (Table 13.1).

The distinctive feature of the Russian pension system that significantly affects pensioner living standards is that because of the absence of strict retirement conditions a substantial share of pensioners are involved in income-generating employment. In 2000, 6.1 million pensioners were working pensioners (simultaneously receiving pensions and employment income). In general, the number and the percentage of working pensioners within the total number of pensioners has tended to reduce (from 8.0 million persons or 21.9% in 1994 to 6.1 million persons or 15.9% in 2000, respectively). These indicators peaked in 1996 (8.9 million persons or 23.5% of pensioners), with the employment rate of pensioners subsequently going down.

In 2000, among a total of 38.4 million pensioners 36.4 million were receiving labour related pensions and 2.0 million received social pensions. Among recipients of labour related pensions, 28.8 million persons had old age pensions (of whom 8.5 million persons received so-called privileged and special pensions), 4.8 million received invalidity pensions, 2.1 million received survivors' pensions, and 0.7 million received long-service pensions.

One of the main characteristics of the pension system in Russia is that there are various types of privileged pensions and special pensions, some of which allow earlier retirement – at an age as early as 45 years. For example, such categories include persons working in dangerous or hazardous conditions, those working in the extreme north, mothers bearing five and more children, etc. Such persons have the right by law to retire earlier than the officially fixed, normal retirement age. In

reality, significant proportions of such employees retire five to seven years earlier than the standard age.

The indicator most significantly influencing pension provision has been the sharp deterioration in the demographic support ratio for the current pension scheme. The number of those employed in the economy per pensioner dropped from 2.02 in 1992 to 1.66 in 1998, and then slightly increased (1.68 in 2000), due to the economic recovery accompanied by employment growth (Table 13.1).

Most of the decrease in this ratio was caused by two factors. The first was the sharp contraction of employment following the economic restructuring, due to Russia's involvement in the global economy and the transition of the country to a market-oriented economic model. The second factor was the gradual increase in the number of pension recipients.

The legislative framework influencing pensioner living standards

In Russia, there are both national and local strategies to assist the different categories of pensioners and older people in general, in meeting their needs and providing them with a decent standard of living. The legislative framework providing for improvements in pensioner living standards already exists and is continually being improved. The guarantee of social security and state pension provision is fixed in the constitution (Article 39).

The legal norms concerning the living standards of Russian pensioners and touching upon the interests of elderly people are contained in a number of state laws, presidential decrees, and government acts that are in force at the national level. In this respect, there are also rules and regulations in force at regional and municipal levels.

The main federal laws containing statutory regulations defining the living standards of pensioners in Russia are the following:

- The Pension legislation consisting in turn of a number of federal laws.
- The Civil Code of the Russian Federation.
- The Family Code of the Russian Federation.
- The Housing Code of the Russian Federation.
- The Labour Code of the Russian Federation.

The dynamics of some key indicators of pensioner living standards and social security during transition

The following social problems were the most painful in Russia during the period 1992 to 1999:

- The increase in the differences between the living standards of different groups of the population.
- The decline in the real value of wages, pensions, and other types of money incomes due to inflation.
- The poverty of a significant part of the population.

– Growing regional disparities in living standards.

– The occasional belated response of the system of social aid to the negative consequences of the reforms.

Trends in some of the key indicators of pensioner living standards and pension security in Russia in the period 1992-2000 are given in Table 13.1. Analysis of the data provided in Table 13.1 leads to the conclusion that extremely severe changes in social and economic life inevitably resulted in a clear decline in population living standards. This is shown first of all by a drop in practically all types of incomes in real terms − wages, pensions, allowances, stipends, etc., during the years of transition.

The fall in living standards was initially brought about by price liberalisation (from 1 January 1992) and by the emergence of the new economic and social model in the country. The liberalisation of prices cut by nearly half the real value of the average income of the population, so that in 1992 it was equivalent to only 52.5% of the 1991 level. The average wage in real terms in 1992 was 67% of that in 1991. The same holds true for the real value of social security benefits. The real gross monthly pension in 1992 was 52% of that in 1991, the real old-age minimum pension was only 44%. Later, in 1993-1994, the real value of these incomes went up.

The second fall was mainly caused by the financial crisis of October 1994 (the so-called "blue Tuesday"). Real wages and pensions decreased significantly in 1995, although once again, the situation slightly improved in 1995-96. And finally, the third decline in living standards was in 1999, as a consequence of the financial crisis of August 1998. This was much more severe than the crisis of October 1994. The well-being of most of the population was badly affected by the crisis of August 1998, which was accompanied by a sharp increase in inflation. As a result, the real value of pensions and wages, etc., dropped very sharply. The 1998 crisis reduced the real value of wages by 22% and the real value of the average pension by 39.4%.

Table 13.1 also shows trends in the ratio of four income indicators − per capita money incomes, average wages in the economy, the average pension, and the minimum old-age pension − to the average official federal level of the minimum subsistence amount for the respective socio-demographic population groups. The crises caused a significant deterioration in these four ratios. In 1999, the average wage of an employee was only 152% of the subsistence minimum for the able-bodied population. In this year also, the average pension was 70% of the subsistence minimum for a pensioner. These are the lowest ratios during the transition period.

Throughout all the years of reform, the minimum old-age pension was lower than the amount of the average subsistence minimum of a pensioner. In 1992, the minimum old-age pension was 83% of the subsistence minimum of a pensioner. In 1995, after the financial crisis of October 1994, the amount went down to 48%.

The worst ratio between the minimum old-age pension (including compensation) and the subsistence minimum of a pensioner was in 1999, after the crisis of August 1998, when the amount of the minimum old-age pension went down to 45% of the subsistence minimum of a pensioner. Meanwhile, according to the Order of the President of the Russian Federation "On Measures to Support Material Provision of the Pensioners", dated 14 June 1997, No 573, the amount of the minimum pension with compensation, could not be less than 80% of the subsistence minimum for a pensioner.

At the same time, there was another side to the problem, in that the pension indicators between 1992 and 1999 fell slightly less sharply than wages indicators. The ratio of the average pension to the

subsistence minimum for a pensioner did not deteriorate as quickly as either the ratio of the average per capita money incomes to the subsistence minimum amount for the whole population, or the ratio of the average wage to the subsistence minimum for the able-bodied population. The only exception was perhaps in 1999. In any case, the average pension was kept above the subsistence minimum amount for a pensioner for almost all the years of the transition period, despite the difficult political and economic circumstances related to the transition.

The ratio of the average pension to the average wage shows, on the whole, a positive trend as well. The ratio of the minimum gross monthly old-age pension to the average monthly minimum wage looks the most favourable. It increased from 157.1% in 1992 to 396.8% in 2000. This has to be considered to some extent as a social policy success for pension security.

When analysing pensioner living standards in Russia, the problems that the country faced, mainly in 1996 and in 1998, should not be forgotten. The first problem was that the falling number of employees contributing insurance payments to the Pension Fund of Russia aggravated the problem of pension security. The second problem was that non-payment, or delays in payment, of wages in the economy also caused non-payment and delays in payment of social security contributions, as well as evasion of payment of these contributions. This was clearly the major reason for the contribution gap. Roughly half of Russia's enterprises experienced financial difficulties at this time.

The year 1996 was the first year during transition when the level of social security contribution collections decreased, due to the growing wage arrears of enterprises. Wages were being paid partly in kind. Barter transactions, as a means of payment between enterprises, became a widespread phenomenon in the economy. In many regions, neither all wages nor all pensions were paid on time.

Thus, the deterioration in the pension indicators was caused by non-payment and delays in payment of wages, accompanied by contribution payment evasion and contribution collection arrears. This, in turn, led to pension arrears. 1996 and 1998 were the peak years of pension arrears (Table 13.1).

When considering trends in key indicators of pensioner living standards during transition, special attention should be paid to the period since 2000. Due to the fact that Russia has been experiencing economic growth since the second half of 1999, the indicators of the living standards of the population have also begun to grow.

The average real income of the population in 2000 was 109.3% of that in 1999. The average wage in real terms in 2000, 121% of the 1999 level. The real gross monthly pension in 2000 was 128% of that in 1999. Wage arrears dropped from 77 billion roubles in 1999 to 43.7 billion roubles in 2000 and to 31.7 billion roubles in 2001.

As for the data available for 2001, the following figures can be provided. In the period 2000 to 2001, real incomes went up 5.9%, real wages increased 19.8%, and the real average pension increased by 21.4%. In 2001, as compared with 2000, the total number of unemployed (according to the ILO methodology) fell by 14.9% and the number of registered unemployed decreased by 1.9%. There were no pension arrears in 1999-2001.

The development of the above-mentioned indicators seems to be favourable in 2000-2001, giving some grounds for optimism about future improvements in pensioner living standards.

Causes and factors influencing pensioner living standards and defining differences in living standards of different categories of pensioners

The following factors can be used to define a typology of pensioners by standards of living in Russia:

- The amount of pension received compared with the pensioner's subsistence minimum.

- Non-payment or delays in payment of pensions (this was the case only for 1996 and 1998).

- Whether the cost of living of a pensioner significantly differs by region. A pensioner's subsistence minimum does vary by region, according to regional costs of living. However, all types of pensions are provided at the same amounts throughout the country. The same amount of pension may be the equivalent of, say, 75% of the pensioner's subsistence in one region, but at the same time this same amount may be the equivalent of 120% of the pensioner's subsistence amount in another region.

- The level of "wealth" of the region in which a pensioner resides. In Russia donor (rich) regions (regions with a positive annual balance between incomes and expenditures) often provide pensioners who have a low level of pension with a supplementary pension. Recipient (poor) regions cannot do this because of their financial constraints. In most of the donor regions there are regional programmes of supplementary pensions paid from regional budgets.

- Pensioner status from the point of view of income–generating employment. In this context, as mentioned above, it is possible to distinguish, among Russian pensioners, working pensioners (who have simultaneously both a pension and an employment income) and non-working pensioners (for whom the pension constitutes the sole source of income). Among working pensioners, special attention can be paid to "young pensioners", among whom there are many who work for the first five years after retirement. These are women aged between 55-59 and men aged between 60-64. According to the data available, nearly 50% of male "young pensioners" and nearly 40% of female "young pensioners" have a job, and thus have an employment income. At the same time, it should be pointed out that the workplaces usually occupied by pensioners are not the most attractive or high-paid, compared to those occupied by younger (middle-aged) employees. Nevertheless, for various reasons pensioners are often interested in having a job (even a comparatively low-paid one) and a salary. Thus it follows that the pensioner's wage is positively linked to the household's wealth.

- Resources of a pensioner's household, including some types of ownership (*e.g.* a room in an apartment, a garage, etc.) that can be rented to another person.

- Ownership of a piece of land together with agricultural production from it can provide a pensioner with some sorts of food (*e.g.* fruits, vegetables, potatoes, etc.).

- The state of health, the level of physical and social activity, the age and gender of a pensioner. These indicators may determine whether, under otherwise equal conditions, there is an opportunity for a pensioner to be employed, and thus to have an employment income.

Family status and co-residence conditions are among the most significant factors affecting pensioner living standards, and are key indicators of an elderly person's actual situation. From this point of view it is possible to distinguish:

- Pensioners who live alone.
- Pensioners who live under the same roof with their adult and working children, and correspondingly with their children's children (these families are usually called extended families or multi-generation families).
- Married pensioner couples.
- Single elderly pensioners, including single pensioners of senior age living alone, disabled pensioners without relatives and living separately.

Single pensioners in the older age groups who live alone – the overwhelming majority of whom are women – are a group particularly likely to be classified as vulnerable and as having a lower wellbeing than other pensioners. Their needs are determined, first, by their demographic characteristics (age, health, and incapacity) and second, by their low level of pensions. For poor lonely pensioners in the older age groups, the pension constitutes the sole source of income.

Pensioner living standards: comparisons with the pensioner subsistence minimum and living standards of other population groups

In order to analyse the actual living standards of pensioners, it is not enough to study the level and the trends in nominal and real pensions, or simply to identify the factors influencing the living standards of different categories of pensioners. It is also necessary to compare the living standards of pensioners with that of other groups in the population, using uniform criteria for this comparative analysis.

As the uniform criteria for Russia, it is proposed to take the subsistence minimum amount calculated for different socio-demographic groups in the population.[1] Differences in living standards between different categories of pensioners and other population groups can be found by comparing the incomes of the relevant population groups with the subsistence minimum, and by measuring the gap between these two indicators. The detailed data on the share of different groups of the population and households with per capita money incomes below the subsistence minimum amount in 2000 are given in Table 13.2.

The data based on the criteria of comparing per capita money incomes with the subsistence minimum amount by different households and population groups show the following results. Categories of the population such as families with children, families with unemployment benefit recipients, and temporarily non-working persons, found themselves in the most difficult position in 2000, compared with most pension recipients. The greater the number of children in a family, the greater the share of such families with per capita money incomes below the subsistence minimum.

1. The data on the number and the percentage of the population with money incomes below the subsistence minimum are applied as officially established poverty indicators in Russia, and hence households with average per capita money incomes below the subsistence minimum are considered to be in poverty. The subsistence minimum amount per capita is calculated nationwide for both the overall population and for the major socio-demographic population groups (for a man and a woman of able-bodied age, for a pensioner, and for children of different ages).

Depending on family type and size, between 79% and 93% of the surveyed families with 3 or more children, had per capita money incomes below the subsistence minimum, with between 51% and 72% being below half the subsistence minimum. The same indicators for families with unemployment benefit recipients amounted to 73% and 39% respectively.

Even for families with one or two children, the situation was worse than that of most pensioners. More than 50% of all households with one or two children had per capita money incomes below the subsistence minimum, and more than 20% of these households had per capita money incomes less than half the subsistence minimum.

In contrast, these indicators for the families of non-working pensioners were 32% and 7%, respectively, and for old-age pensioners 38% and 10%, respectively. Working pensioners, due to their supplementary employment income, had the most favourable indicators – 25% and 6% respectively. Therefore, for of those with per capita money incomes less than half the subsistence minimum (the indicator of extreme poverty), it can be seen that this indicator is again more favourable for the majority of pension recipients.

At the same time, there is a clear gap between the living standards of different categories of pensioners. This is shown by the differing shares which different categories of pensioners have, of those with per capita money incomes below the subsistence minimum and those with incomes below half of the subsistence minimum. Groups such as handicapped pensioners, recipients of survivor's pension, and recipients of the social pension, are in the worst position. For example, for handicapped pensioners, poverty is almost 1.5 times higher, while extreme poverty is more than twice as high as for old-age pensioners in general.

This analysis leads to an important conclusion. The share of poor pensioners is significantly less than that of the population as a whole, and than that of the other groups surveyed, including those employed. The poverty risk for most pensioners is lower than the average for Russia. Handicapped pensioners, recipients of survivor's pension, and recipients of social pensions, especially those residing separately and without relatives, are an exception to this conclusion.

Thus, the pension system continued to work in the difficult conditions of the transition economy and managed to keep millions of elderly and disabled persons out of severe poverty at least. Without these transfers through the pension system, even if their payment was subject to delay, pensioners would have formed the core group of the poor. Thus, a major part of the pension system has had the effect of at least preventing severe poverty. This is a fact that is often overlooked by those who criticise the Russian social protection system.

Social policy measures and instruments to improve pensioner living standards

The main social policy measures and tools directed to improving pensioner living standards are briefly listed below.

1. Pension reform

Raising pensions and increasing their purchasing power are among the top priorities of social security policy.

2. Federal targeted programme "The Older Generation"

This programme, approved by the Russian government, has been underway since 1997. It contains measures to be carried out in priority areas in the interest of elderly people. The programme measures are financed from the Federal budget and off-budget sources. The programme is designed to:

- Expand the network and improve the performance of institutions and agencies providing elderly people with vital, socially-oriented services.

- Develop new social services, taking into consideration the scale and rates of population ageing, and create the conditions for introducing economically viable models and balancing the standards of social services with the needs of society.

- Promote elderly people's social adaptation and strengthen social relationships, and simultaneously expand senior citizens' socio–cultural contacts.

- Sustain elderly people's physical activity by rehabilitation and health improvement measures.

- Promote elderly people's social integration with assistance from social services institutions and NGOs, and by continuing third-age education.

- Stimulate co-ordination between Federal executive agencies and their counterparts in the regions of the country to combine their efforts to deal with the older generation's urgent life-support problems.

- Conduct research projects on priority aspects of social security for senior citizens.

3. The adjustment of pensions in line with inflation

Since the beginning of the transition period, the Russian government has attempted to preserve, to some extent, the real value of pensions. All the successive adjustments to the pension were intended to maintain the average pension at a level higher than the subsistence minimum of a pensioner, and to prevent too severe a decline in the average pension in real terms. The adjustment of pensions is carried out simultaneously in two ways. The first is through the indexation of pensions, and the second is by providing low-income pensioners with compensatory payments, or by increasing their amount. Compensation payments are not considered as part of the pension. As a rule, pensions are indexed and compensatory payments are increased two to four times a year depending on the rate of inflation. In 2000, the adjustment of pensions was conducted three times.

4. Providing low-income families with social aid[2]

According to the Federal Laws "On Subsistence Minimum in the Russian Federation" dated 1997 and "On State Social Aid" dated 1999, a family or a citizen living alone and with a per capita income below the officially fixed subsistence minimum has the right to obtain social aid. Some categories of elderly people and pensioners are covered by this social aid. The procedure for inclusion in this programme is applied in such a way so as not to exclude low-income elderly people and single

2. In the opinion of the author, this provision is like a social allowance (or a poverty allowance) in some Western countries.

pensioners residing alone with per capita incomes below the subsistence minimum. As specified in the Federal Law "On State Social Aid", social aid can be obtained both in money and in kind (heating fuel, foodstuffs, clothing, footwear, etc.). These include the following.

- The state programme of protecting low-income families by providing them with means-tested housing allowances.

- Subsidies in payment for housing and communal services that are directed to the most economically weak groups of the population, including some categories of pensioners.

- Providing some categories of elderly and handicapped persons with free medicines and subsidies when paying for medicines (medicine discounts).

- Discounts for payment of telephone bills and for services in some social institutions, free city transport, free meals in social dining rooms, etc. are provided to some categories of pensioners.

Some conclusions

Currently, the problem of pensioner living standards is not as severe as it was at the beginning of the reform process. According to various estimates, the well-being of most older citizens has gradually improved for at least the last two to three years, particularly in comparison with the well-being of a significant part of the employed population.

On the one hand, this has been the result of positive moves, such as increases in the level of pensions, and the preservation or even expansion of different types of social allowances and subsidies for groups of pensioners, etc. On the other hand, this result is based on undesirable social and economic facts, such as the existence of relatively high unemployment rates, particularly for young people, and extremely low wages for some groups of employees.

In addition, a relatively high share of pensioners continues to work, and hence, in addition to pensions, has another source of income − employment income. This gives working pensioners clear advantages compared to those employees with poor labour skills and occupying low-paid positions, and who also do not receive the different kinds of advantages and subsidies provided to pensioners.

At the same time, categories of pensioners such as handicapped pensioners, recipients of the survivor's pension, recipients of the social pension, and recipients of the minimum old-age pension, particularly the very elderly as well as those residing separately and without relatives, are in the worst position. These categories of pensioners must be given special attention by the development of further social policy measures.

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Table 13.1. Trends in key indicators of pensioner living standards and pension security in Russia for the period 1992-2000

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Number of pensioners registered in offices of social protection of population (at the end of year), million persons	35,3	36,1	36,6	37,1	37,8	38,2	38,4	38,4	38,4
Number of those employed in economy, per pensioner (at the end of year)	2,02	1,94	1,84	1,80	1,76	1,70	1,66	1,67	1,68
Number of working pensioners, million persons			8,0	8,4	8,9	8,7	7,2	7,1	6,1
Ratio of working pensioners to number of pensioners registered in offices of social protection of population, %			21,9	22,6	23,5	22,8	18,8	18,5	15,9
Consumer price index, % to the previous year (December, as % of December of the year before)	2608,8	939,9	315,1	231,3	121,8	111,0	184,4	136,5	120,2
Average monthly per capita money incomes, thousands roubles, since 1998 – roubles	4,0	45,2	206,3	515,4	769,2	940,8	1007,8	1629,6	2192,9
Real disposable money incomes, % to the previous year	52,5	116,4	112,9	84,9	100,5	105,7	83,8	86,2	109,3
Average monthly payroll wage of an employee, thousands roubles, since 1998 – roubles	6,0	58,7	220,4	472,4	790,2	950,2	1051,5	1522,6	2223,4
Real average monthly payroll wage of an employee, % to the previous year	67	100,4	92	72	106	105	87	78	121
Average gross monthly pension (considering compensation payments), thousands roubles, since 1998 - roubles	1,6	19,9	78,5	188,1	302,2	328,1	399,0	449,0	694,3
Real gross monthly pension, % to the previous year	52	131	97	81	108,7	94,6	95,2	60,6	128,0
Average monthly minimum wage, thousands roubles, since 1998 - roubles	0,7	6,1	17,6	42,5	72,7	83,5	83,5	83,5	107,8
Real average monthly minimum wage, % to the previous year	41,5	93,3	70,9	81,4	115,8	100,0	78,3	53,9	106.9
Minimum gross monthly old age pension (considering compensation payments), thousands roubles, since 1998 – roubles	1,1	11,3	40,7	89,6	190,4	222,0	234,2	290,3	427,8
Real gross monthly old age minimum pension, % to the previous year	44,0	105,5	88,1	74,1	143,7	101,6	82,6	67,0	122,0
Ratio of average gross monthly pension to average monthly payroll wage, %	26,7	33,9	35,6	39,8	38,2	34,5	37,9	29,5	31,2
Ratio of minimum gross monthly old age pension to average monthly minimum wage, %	157,1	185,2	231,3	210,8	261,9	265,9	280,5	347,7	396,8
Ratio to the subsistence minimum (for the respective socio - demographic population group) , %									
Average monthly per capita money incomes	210	220	238	195	207	227	203	177	181
Average monthly payroll wages of an employee	281	254	226	159	190	206	189	152	168
Average gross monthly pension	119	138	129	101	116	113	115	70	76
Minimum gross monthly old age pension	83	79	67	48	73	77	67	45	no data
Wage arrears, trillion roubles, since 1998 - milliard (billion) roubles	-	0,03	0,8	4,2	20,8	48,6	52,6	77,0	43,7
Pension arrears, trillion roubles, since 1998 - milliard (billion) roubles	-	-	-	0,7	15,7	-	26,3	-	-

Source: "Social Situation and the Living Standard of the Population in Russia" for the corresponding years. *The Statistical Yearbook*. Goskomstat (State Committee on Statistics) of Russia; "Socio-Economic Situation in Russia" for the corresponding years. *Monthly Statistical Digest*. Goskomstat of Russia.

Table 13.2. Share of households and population with per capita money incomes below the subsistence minimum amount in 2000, as % of the total number surveyed

Social and demographic types of households and population groups	Below the subsistence minimum	Twice or more below the subsistence minimum
All households surveyed	42.2	13.4
Two parent families		
Spouses without children	28.6	6.2
Spouses with 1-2 children	51.8	20.1
Spouses with 3 children and more	79.2	50.7
Single parent families		
Single parent families with 1-2 children	55.9	21.6
Single parent families with 3 children and more	93.6	71.8
Households with unemployment benefits recipients	72.6	38.9
Households of non-working pensioners	31.7	6.7
All population surveyed	49.3	18.7
Hired workers	44.4	15.3
Entrepreneurs	29.2	12.3
Temporarily non-working	65.4	33.9
Non-working pensioners	43.0	12.6
Working pensioners	24.9	6.0
Old-age pensioners	37.9	10.0
Handicapped pensioners	55.6	22.2
Recipients of survivor's pension	62.0	26.1
Recipients of social pension	64.2	27.4
Recipients of unemployment benefits	74.6	41.6

Source: Population Budget Surveys Data. Goskomstat (State Committee on Statistics) of Russia.

Chapter 14

THE GENDER IMPACT OF PENSION REFORMS: CASE STUDIES OF THE CZECH REPUBLIC, HUNGARY AND POLAND

by
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Introduction[1]

The restructuring of social security has been a critical component of the larger economic and political transformation under way in Central and Eastern European (CEE) countries during the 1990s. While a wide variety of social policy reforms have been implemented, pension schemes have been the focus of the greatest deliberation, controversy, and action. Early in the decade, these schemes were used to absorb high unemployment through liberal early retirement and disability provision. Later in the 1990s, with their financing destabilised by the early events of the transformation, governments sought to strengthen the solvency of their pension schemes and to modernise certain features to match the new economic environments in which they were operating. Several common themes can be discerned in these reforms. They aimed to: separate pension scheme financing from other branches of social security and, in many cases, from the state budget as well; increase retirement ages; reduce redistribution in benefit formulas and make benefits more earnings-related; establish supplementary private pensions; eliminate the privileges available to some categories of workers during the socialist period; and provide regular benefit adjustments for inflation, in many cases moving from wage indexation to heavier reliance on prices.[2] In several CEE countries, governments are in the process of privatising a portion of the public pension scheme. In some countries, *e.g.* Hungary, Poland and Latvia, legislation on the partial privatisation has been approved and is being implemented.[3] This has turned out to be among the most contentious and challenging of the reform measures.

The politics of pension reforms, and preliminary experiences with them have come under study from a variety of different perspectives – for example, in terms of poverty alleviation, promoting economic development, and strengthening work incentives.[4] Yet the debate on pension reforms in CEEs has so far been characterised by a very limited focus on gender equality. This is true both with

1. Elaine Fultz, Senior Social Security Specialist, of the International Labour Organisation Central and Eastern European Team, has provided vital comments and insights. Remaining errors are, of course, solely the author's responsibility.

2. Müller (2002).

3. Fultz and Ruck (2000).

4. See, for example, Fultz (ed.) (2002). For a discussion of the distributional effects of pension reforms, including gender, see also Stanovnik (2002).

respect to the dynamics of the reform process, as well as the preliminary assessment of the reform initiatives underway, and their distributional consequences.[5]

One explanation for this "blind spot" can be found in the controversial and unsettled nature of the topic of gender equality in social security itself: should the focus be on social security schemes proper when investigating their gender impact, or should account be taken, and to what extent, of the fact that schemes operate in a socio-economic environment, which is itself characterised by gender inequality? The latter approach implies that formal equality within a social security scheme would cease to be the primary objective. Rather, social security would be structured to equalise and compensate for inequality in the environment in which it operates. This question of how to look at gender equality vis-à-vis social security, narrowly or broadly, is one on which not much guidance is found in the literature.[6] While the author concludes that a broader view is most appropriate, insights can be gained by looking at gender equality in social security both ways.

In addition, the analysis of gender equity in the CEE context is complicated by particular characteristics of the region. Firstly, women obtained some advantages during the socialist period, such as lower retirement ages, which would be lost, or lost in part, under a scheme organised to guarantee formal equal treatment.[7] Thus, while gender equality is usually thought of as bringing benefits for women, in the Eastern European regional context it often implies losses of longstanding entitlements. This is a rather bitter pill to swallow for advocates seeking gender equality as a way of enhancing the rights and status of women. Only further research and debate will lead to adequate responses. Politically, this particularity creates a potential obstacle to mobilisation in favour of gender equality.

Second, the views and interests of women who are organised to exert political pressure in CEE countries vary, often depending on their employment position, income, age or family situation.[8] Also, the experience of transformation, particularly of the narrowing options for women on the job market, has led some women to retreat from the professional aspirations they held earlier.[9] At times, we also find an unhappy conjunction between women's voluntary retreat from the labour force and the popular view that in times of high unemployment women should withdraw, rather than compete with men, for the fewer available employment opportunities. In combination, these factors surface as small but

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5. The lack of a gender analysis of social security reforms is not a particularity of this region, however. Gender assessments are relatively few in number elsewhere. Exceptions include, for Latin America, Bertranou (2001), Arenas de Mesa and Montecinos (1999) and Cox Edwards (2001). For the Former Soviet Union, see Castel and Fox (2001). For Western Europe, see Leitner (2001), Behning and Leitner (1998) and Klammer (2000).

6. Instead, it is common to regard both approaches as complementary, which, at least in the context of CEE, turns out not to be appropriate (see, for example, ILO, 2001).

7. Women's treatment in CEE social security can, at least in part, be considered an outcome of the socialist ideology of promoting women's full employment (while in fact leaving the division of labour between women and men at home intact). Under these conditions, social security was designed to facilitate women's employment, and it *de facto* compensated women for disadvantages suffered in the overall economic and social environment.

8. For example, the dispute about an initial proposal for equalising women's and men's retirement ages in Poland can be interpreted as one between younger and better educated women, who favoured an equal retirement age, and older and/or less educated women, who preferred an earlier retirement age. The latter resisted equalisation as a taking-away of a long-held and cherished provision.

9. For an analysis of gender asymmetries in transforming CEE labour markets, see sections on the labour market in all three country studies (in draft), Ruminska-Zimny (2002) and Steinhilber (2001).

significant losses of support for women's full employment. Polls in Hungary have shown a decline in popular support for women's full time employment between 1988 and 1995. In 1995, about a third of the respondents disapproved of women's labour market participation altogether, and believed that women should devote themselves to child raising and housekeeping. Support for women's full employment was about 15 percentage points lower than in 1988.[10] These different priorities with respect to social security – support for mothers and homemakers on the one hand, and equal opportunities and treatment for fully employed women on the other – complicate efforts to operationalise the concept of gender equality in CEE and to set priorities for action.

How have these complexities impinged on the pension reform processes underway in CEE? This is the central question posed by a study initiated in 2001 whose preliminary results are presented here. The study is sponsored by the International Labour Organisation Central and Eastern European Team[11] and is being undertaken as part of a larger regional social security technical co-operation project supported by the French government. The purpose of this project is to capture the experience of CEE countries which have already undertaken major social security reforms, so that this information can be used by other countries which are still in the process of deciding how to restructure social security. In this way, the project seeks to promote regional information sharing and learning from the experiences of those that took action early. In addition, the particular purpose of the study on the gender impact of reforms is to promote gender equality as an issue worthy of more extensive policy deliberation and action. The study looks at the experience of three countries, the Czech Republic, Hungary and Poland, focusing not only on pensions but also on maternity benefits, family benefits, and child care benefits. This presentation will focus only on pensions, however. While the study is still being finalised, the main gist of the analysis is clear. This presentation will concentrate on five main patterns that have grown out of the country analyses:

- First, and perhaps not surprisingly, gender equality was a secondary issue in the pension reforms examined. In all three cases reforms were driven mainly by other concerns. As will be shown, this limited focus has led to some unforeseen disadvantages for women.

- The reforms have advanced formal equal treatment of women and men, as narrowly defined within the pension scheme itself. However, this has not been of great significance for women due to the influence of inequalities in the wider environments in which the schemes operate (principally, unequal wages and the unequal sharing of unpaid care work between women and men).

- One major thrust of the reforms, a closer linkage between contributions and benefits, is generally detrimental for women because of the gender wage gap and the disproportionate role of women in unpaid caring responsibilities.

- Special problems have arisen for women in privatised pension schemes, with respect to caring credits and the role of life expectancy in computing private annuities.

- Projections show that a highly detrimental combination for women's old-age security is a) a continuing early retirement age for women and b) a notional defined contribution (NDC) system in the public pension tier, as is the case in Poland. This combination raises the prospect of significantly increased poverty among women pensioners.

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10. Central Statistical Office (1988) and Frey (1996).

11. Where the author worked as associate expert on gender equality and women workers' rights during 1999-2001.

Each of these five main patterns will be elaborated in some detail below, followed by concluding remarks.

The gender impact of reforms – main patterns

Gender equality has not been a driving force in any of the pension reforms. This limited focus has led to unforeseen disadvantages for women. The great diversity of women's views and interests with respect to social security was one main obstacle to their effective participation in the reform discussions as a unified interest group. The still relatively weak CEE women's organisations have not placed social security reforms at the top of their priorities for action.[12] In addition, women's representative participation in political decision-making has drastically declined in the first years of the transformation process, so that women's voices could not be heard strongly in the political realm.[13] Finally, policy analysis from a gender perspective on the different areas of transformational reforms is a relatively recent development in the region. As a consequence of all these factors, there is little public awareness about gender equality, among decision-makers, pension experts and the general population, and there has not been an influential "gender-lobby" in any of the countries under study.

In the early years of the transformation process, gender issues were trumped by other apparently more immediate concerns. Initially, governments saw macroeconomic and political reforms as the most pressing. Through liberal early retirement and disability provisions, the existing social security schemes, prominently pension schemes, served to buffer soaring unemployment and hardship resulting from the economic transformation. Pension schemes thus contributed to the political stabilisation of the new democracies during the early years of the transformation period.[14] Later in the 1990s, fiscal concerns dominated the reform debates, creating a climate of belt-tightening, and a situation where government's capacity to compensate losers from reform measures was highly constrained. Under these circumstances, gender issues were only addressed in a limited way, if at all, or, as in the case of the retirement age, by imposing a disproportionate burden on women.

The social security reforms have advanced formal equal treatment of women and men in pension schemes. This has, however, on the whole not been a significant achievement for women, and has even been to their disproportionate disadvantage in some cases. In a range of provisions, women and men were treated differently in the old pension schemes, notably with respect to their retirement age, survivors' benefits and caring credits, which either treated women favourably or were exclusively available to them. The reforms have advanced formal gender equality by equalising eligibility criteria and making benefits available for men where they had been limited to women before. Table 14.1 illustrates these changes in favour of more formal gender equality.

In all three countries, women's retirement ages had been lower than men's in the pre-reform pension systems. In Poland, men could retire at 65 (with 25 years of service), women at 60 (with

12. The secondary importance of social security on the agenda of women's organisations was shown by the results of a qualitative survey conducted as part of the study. The results of this survey will be included in the overall study (in draft).

13. Women's representation declined massively, both in elected political bodies and senior decision making posts. It has been growing again slowly, but only in recent years. See UNICEF/ MONEE (1999).

14. See Götting (1988) and Müller (1999).

20 years of service).[15] In Hungary, men retired at 62, women at 57. In the Czech Republic, men retired at 60 and women at 53-57, depending on the number of children (one year less per child).

The Polish pension reform did not entail a rise in the retirement age, and the five-year difference for women and men was maintained.[16] In Hungary, pension ages for both women and men will be equal at 62 as of 2009. Thus, equality has been achieved by raising women's retirement age five years. In the Czech Republic, the difference between women's and men's retirement age has been reduced to one year (61 for women, 62 for men), but women's retirement age continues to be lowered depending on the number of children she has (one year per child).

Similarly, the criteria for survivors' benefits have been equalised through the reforms. Where survivors' benefits had not been available for men before (in Hungary and the Czech Republic), they are so now. Equalisation of the entitlements to survivors' benefits proceeded gradually in both countries. In 1991, survivors' benefits were made available to men in principle in both countries, but according to different rules than for women. In a later step, eligibility criteria were equalised. Also, in the course of the reforms, caring credits, *i.e.* provisions to take care leave periods into account for the accumulation of pension rights, were made available for men according to the same criteria as for women in all three countries.

Clearly, more formal equality between women and men has been achieved through the reforms. However, equalising the eligibility criteria for women's and men's pension benefits in these three areas has, on the whole, not been an important achievement for women. Instead, equalisation has been achieved at a greater cost for women than for men (in the case of retirement ages), or has come alongside benefit restrictions for both women and men (survivors' benefits and caring credits), while women continue to be the majority of the users of these provisions. In Hungary, only women's retirement age was raised while men's remained unchanged; in the Czech Republic, women had to bear greater increases in their retirement age than men. Thus, while equalising the pension ages will lead to higher benefits for women in the longer run, the burden is shared unequally in the short run. A higher retirement age also creates hardship for those women who care for their grandchildren or other family members, and for the families that depend on this kind of family support.[17] In the Czech Republic, a woman's retirement age is still automatically reduced if she is a mother, regardless of whether or not she has been the primary caretaker. This reflects the traditional view of women's role as "natural" caretaker and is not an adequate measure to promote a more equal sharing of care responsibilities.

The equalisation of benefit entitlements for survivors' benefits has also brought more formal gender equality. In practical terms, however, equalisation has brought improvements only for men, while survivors' benefits are, in a vast majority of cases, used by women. Similarly, caring credits for men are an achievement from a gender perspective. From what we know, however, men are not using them in significant numbers.

A closer linkage between contributions and benefits, as well as greater individuality in pension rights is generally detrimental for women, given their inferior position in the labour market and the

15. Because of generous provisions for early retirement, the effective retirement age in Poland was lower: 59 for men, and 56 for women.

16. The effective retirement age in Poland will go up, however, because the generous provisions for early retirement are being phased out.

17. Information on the availability and affordability of childcare benefits and institutions in all three countries will be provided in the overall study (in draft).

disproportionate amount of unpaid care work done by women. As a common trend, pension reforms have linked pension benefits closer to lifetime earnings and have increased the role of individually accumulated pension rights in relation to the level of benefits, by introducing private pension savings accounts (voluntary and/or mandatory) and by reducing redistribution in benefit formulas. Table 14.2 presents an overview of the relevant changes towards greater individuality in pension rights in Poland, Hungary and the Czech Republic.

The major difference between the Polish and Hungarian reforms lies in the extent to which public pension schemes were restructured in parallel with the privatisation.[18] In Hungary, the 1998 reform left the public defined benefit structure largely intact and, where changes were made, delayed the dates when they would take effect for more than a decade. Consequently, redistribution in the benefit formula will gradually decrease but continue until 2009. The pension scale will not become linear before 2013. In contrast, the Polish reform has revamped the public pension system substantially, replacing it with a new notional defined contribution (NDC) system[19] in which benefits will reflect each individual's contributions in a more nearly linear way.[20] Future pensioners in Poland will receive the benefit they have "paid for" and redistribution toward low-income earners is eliminated.[21] Thus, actuarial fairness has been advanced at the cost of increasing inequality of benefits.[22]

In contrast, Czech governments have so far decided to reform the existing public pay-as-you-go (PAYG) system without privatisation. Private pension savings on a voluntary basis are encouraged; the law provides for a government matching payment up to a ceiling. Consequently, the current Czech pension system is based on two pillars: a basic mandatory pension insurance funded on a pay-as-you-go basis, and a voluntary, fully-funded supplementary pension insurance.

The Czech benefit formula consists of two parts, a flat-rate portion and an earnings-related portion. As a consequence, the formula ensures redistribution of income by providing for a higher return on contributions to low-income workers than to workers with higher incomes: The flat-rate portion constitutes a greater share of the benefit of workers with an income below the average. Besides, the earnings-related part of the benefit gives relatively greater weight to low earnings.[23]

Looking at gender equality and pensions from a broad perspective, that is, expecting that social security should, at least partially, compensate for inequalities created elsewhere, then greater individuality of pension rights gives reason for concern. In a system based on individual accumulation of pension rights and close links between contributions and benefits, gender inequalities in the wider

18. Fultz (2002).

19. In a notional defined contribution system, a quasi-actuarial pension formula is introduced into the public pension tier. All contribution payments are recorded in notional individualized accounts. Capital accumulation is only virtual, however. Individual benefit levels depend mainly on past contributions and their notional rate of return. See Müller (2000).

20. Fultz (2002).

21. Benefits will be automatically decreased in response to increases in average life expectancy, unless workers delay retirement and make additional contributions. See Fultz (2002).

22. Note that NDC schemes not only do away with redistribution between different groups of beneficiaries, for example between women and men, high-income and low-income earners etc., but also abolish redistribution between generations.

23. For workers retiring in 2002, the first 7 100 CZK of countable earnings toward a pension benefit are credited at 100%. Countable earnings between 7100 CZK and 16 800 CZK are credited at 30%, and countable earnings exceeding 16 800 CZK are credited at 10%.

environment have a substantial impact on pension rights and the future level of benefits. Problems arise in particular from persistent gender wage inequality and the, equally persistent, unequal sharing of unpaid care responsibilities between women and men. Women have lower incomes than men on average and tend to have more irregular working lives and longer breaks in their employment histories, which produces an overall shorter work tenure. A lower retirement age for women further exacerbates the problem of women's shorter tenure. A pension system that is based on the individual accumulation of pension rights exacerbates these features of inequality.

It should also be noted, however, that greater individuality of pension rights has produced a small benefit for women in Hungary and Poland: Now, all contributions into a savings account, no matter how small or infrequent, will be reflected in the benefit after retirement. Moreover, since there are no minimum contribution periods required in the private pension accounts, those women with short contribution periods due to family care and irregular employment histories will now accumulate their own pension rights, whereas they might not have reached the required minimum contribution period in the old system. While the individually accumulated pension rights might not guarantee a decent benefit level, the removal of minimum insurance periods also removes a disincentive to labour market participation for those with little hope of a "standard" employment history.

A comparison between the old and new Polish system illustrates the impact of the gender wage gap and shorter tenure in a system with and without redistribution. In the old Polish system, a pension consisted of two parts, a constant element, corresponding to 24% of the average wage and an individual-related element, which depended on the wage and work tenure of a pensioner. The constant element was equal to about a third of the pension for an average wage earner. Its weight in the pensions of low-income earners with shorter tenure was higher than in the case of persons with higher incomes and longer tenure. As women tend to have lower wages and shorter average tenure than men, the constant element in the pre-reform Polish pension system caused women's pensions to be on average relatively higher than if they had been calculated according to purely actuarial criteria. In the old system, women's pensions were about 80% of men's, whereas in the new system, they are only about 73%. Thus, after eliminating income redistribution, the gender wage gap during working years is directly transformed into a gender gap in pensions. One can even observe a compounding effect in the funded portion of the scheme, since those with higher earnings earn larger and faster compounding investment returns over their working years.

In comparison, the reformed Czech pension system still provides for considerable redistribution in favour of women. In December 2000, the average old-age pension paid to Czech women was 82% of the average pension paid to men. Women's average wages, however, were only about 75% of men's. Thus, the redistributive features in the pension system served to offset approximately a third of the gender wage gap.

Special problems with privatised pension schemes have arisen with respect to a) caring credits, and b) gender neutral/gender specific life tables for the calculation of annuities. Pre-reform pension schemes provided not only for the redistribution of income, but recognised pension rights for non-contributory periods, including maternity and child-care leave. Moreover, despite differences in women's and men's average life expectancies, the same life expectancy factors were used for the pension calculations, which constituted an element of redistribution from men to women related to demographic reasons. Both features, caring credits and differences in life expectancies produce particular gender-related challenges in individualised pension schemes.

Pension reforms in Poland and Hungary have changed the extent to which periods of leave for unpaid care work impact the level of a pension benefit. In the old pension schemes, leave periods for unpaid care work were treated generously, although no contributions were paid. Because almost all

persons who take leave for caring are women, this provision was to their general advantage.[24] Changes to the treatment of caring periods were introduced with the reforms. Table 14.3 summarises how caring credits are handled in the two mandatory tiers of the reformed pension systems in both countries after the reforms.

The effects of the changes are most severe in Poland, where benefits under both the first and second tiers will be based entirely on very low contributions during leave periods.[25] However, there is a commitment in principle to subsidising care periods directly from the state budget, although it is not significant in practice. In Hungary, the public scheme continues to provide a redistributory defined benefit (DB) pension at retirement. Periods of receipt of social insurance benefits are treated as if wages were earned.[26] The second tier treats caring leave less generously than the public pension system. As with all second tier contributions, there is no employer or government subsidy, so that pension savings during leave are extremely low. Child-care leave thus has a clearly negative effect on the pension savings of the parent, most often the mother in both countries, but more so in Poland.

Differences in women's and men's life expectancy pose a special issue in pensions, particularly in fully-funded pension schemes. The pension size of women and men, however, differs considerably if life expectancy is taken into account for the calculation of benefits. In all CEE pension schemes prior to reform, redistribution for demographic reasons was provided for, that is despite different average life expectancies of women and men, pension benefits were not actuarially based. This constituted a form of redistribution from men to women.

The Polish and Hungarian pension reforms have not, so far, adequately solved the question of if, and how, redistribution for different average life expectancies of women and men should be continued. Only for the first, public, tier of the pension systems in both countries, has it been decided that, as before the reforms, benefit levels will not vary due to the different life expectancies of women and men.

With respect to the second tier consisting of privately managed pension funds in Poland, as yet no legislation has been passed setting out the factors to be taken into account when an individual's savings are converted into an annuity. Thus, it is not clear whether men and women will have identical periodic benefits, or whether women will have smaller benefits because of their longer life expectancy.[27] If the benefit formula for the second pillar would allow for the use of separate life expectancies for women and men, the gap between women's and men's projected replacement rates has been estimated to increase by 5.5% at retirement age 60, and by more than 8% at retirement age 65.[28]

In Hungary, in contrast, under the pension law annuities must be calculated using gender-neutral life tables in both the first and the second tiers. However, existing private insurance companies have so

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24. It is worth noting though that mandatory military service of men is also credited as a non-contributory period, both in the old and the reformed pension systems.

25. With the exception of maternity, which is an insurance benefit based on previous wages. Contributions in this case are therefore related to the previous income.

26. However, flat-rate child-related benefits (*e.g.* child-care allowance, which is used by a greater number of beneficiaries than the insurance-based child-care fee) have an impact only on the number of contributory years (multiplier in the benefit formula), not the overall income.

27. See Chlon-Dominczak (2002).

28. Chlon-Dominczak (2002).

far shown reluctance to use gender-neutral life tables. There is a risk that forcing a reluctant private industry to treat women and men equally will provoke subtle discrimination against women by adverse selection. To prevent such behaviour, efficient government regulation and oversight would be needed. The language of the Hungarian law, however, may be too loose to ensure strict enforcement of this provision.[29]

Projections show that a highly detrimental combination for women's old-age security is a) a continuing early retirement age for women, and b) a notional defined contribution (NDC) system in the public pension tier, as is the case in Poland. This combination raises the prospect of significantly increased poverty among women pensioners. As a consequence of the transformation of the entire mandatory pension insurance system in Poland, notably the introduction of a NDC system in the public tier, core redistributive elements in the old pension system which had indirectly worked in favour of women have been eliminated.[30] At the same time, the system of individualised accumulation of pension rights ensures formal equal treatment of women and men, but reproduces gender inequality in the wider environment (*i.e.* gender wage gap, shorter tenure of women because of care leave). Moreover, while radically reducing redistributive elements in the benefit calculation, a five-year difference between women and men's retirement age has been maintained, thus barring women from accumulating pension savings during an equal number of contribution years as men.[31]

Projections show that the reform is likely to cause replacement rates[32] to fall to levels below the minimum standards stipulated in ILO Convention 102, with significant differences between women's and men's replacement rates.[33] For average wage earners, women or men (*i.e.* assuming there is no gender wage gap), replacement rates are projected to decline from 65% for men and 50% for women born in 1949 and retiring under the old system to 40% for men and 30% for women born in 1974 and retiring under the reformed system. The decline is illustrated in the following graph (Figure 14.1). Note that with the exception of the transitional rules applied in the first five years of the new system,

29. See Fultz (2002) and Augusztinovicse *et al.* (2002).

30. Specifically, two redistributive features of the old pension system have been eliminated. Firstly, the constant component in the pension formula, 24% of the average wage for all pensioners, has been abolished. The constant component had benefited women indirectly, because it ensured that the pensions of those who earned below the average wage (relatively more women than men) were higher than would otherwise have been the case. Secondly, the old formula had set a cap on the portion of an individual's wage used for benefit calculation, but contributions were paid on the full wage. According to the new formula, a maximum is set both for the benefit calculation as well as for contributions. Now, employees and employers do not pay contributions on earnings exceeding 250% of the average wage. Since there are fewer women among the higher income earners, this provision benefits women relatively less. See Chlon-Dominczak (2002).

31. Ironically, a number of women's organisations were strongly in favour of maintaining the difference in retirement ages when the proposal was initially discussed. Obviously, there is no uniform "women's interest" on this question, since the effect of a higher retirement age depends on individual characteristics such as age or education (see footnote 8). Public support for an earlier retirement age for women has been declining over recent years, but a CBOS (Polish Statistical Office) poll in March 2002 found that still 54% of those surveyed favoured an earlier retirement age for women, even at the cost of a lower pension benefit. In October 1999, 78% had answered yes to a similar question. Support for equal retirement ages had grown over the same period from 19% to 28%.

32. Defined as the ratio between (net) pension and (net) wage.

33. ILO Convention 102 generally calls for a minimum benefit standard of 40% of wages after 30 years of contributions, with provision for an upper limit and floor.

the decision whether to enter the pre-funded second tier or not has little influence on the overall pension size.[34]

If the different earnings patterns of women and men are taken into account, alongside the effect caused by women's shorter overall tenure, two simultaneous effects of the reform come into play.[35] In this case, as illustrated in Table 14.4, replacement rates for both women and men decline after reform, and at the same time, the gender gap in replacement rates grows.

In the new system, the replacement rate for men, retiring at age 65, is projected to be almost twice the rate for women, retiring at age 60. The projected replacement rate is 39.6% for men as compared to 22.4% for women. In the old system, for the same profiles, replacement rates were more than twice as high, for both women and men.

The gender gap in replacement rates between women retiring at age 60 and men at 65 in the old system was roughly 25%. In the new system, the gap in replacement rates is more than 30%. The difference in women's and men's retirement ages explains about half of the gap in pension benefits in the new system. The other half can be explained by wage differences between women and men. Even assuming an equal retirement age for women and men at 65, the reform has increased the gender gap in replacement rates. If both retired at 65 under the old system, the gap was 19%, whereas in the new system it is projected to be 26%.

Conclusion

Gender equality has not been a driving force in the pension reforms in any of the three countries under study. This limited focus has led to some unforeseen disadvantages for women. Particular problems for gender equality arise in pension systems that are strongly based on the individual accumulation of pension rights and which closely link contributions based on lifetime earnings with benefits received. Many of these problems are in fact caused by the influence of gender inequalities in the wider environment in which social security operates (principally, wage inequality and gender discrimination in the labour market, as well as the unequal sharing of care responsibilities between women and men), and which are reproduced in the pension systems. Yet pension systems, to some extent, can also influence gender structures in the larger environment, by either reducing or accentuating existing inequalities. For example, persons who spend years out of the labour market caring for children will accumulate lower pension savings in a system of individualised accumulation of pension rights than persons with uninterrupted employment. The negative impact of caring leave is larger, the higher the income. Thus, the way caring is currently credited in individualised pension systems constitutes a disincentive for higher income earners, most often men, to go on care leave. This is not good news for advocates of changes in gender roles and a more equal sharing of care responsibilities between women and men.[36]

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34. For a more detailed discussion of the assumptions and the methodology of the projections, see Chlon-Dominczak (2002).

35. The scenario uses typical male and female characteristics, according to current statistical data. In the female profile, lifetime earnings are assumed to be at the level of 86% of the average wage in the economy and total tenure is assumed to be 36.2 years (current average tenure plus the difference between the legal retirement age and the current actual retirement age of 55.9). For men, the scenario assumes earnings at the level of 112.9% of the average wage and average tenure of 42.4 years (Chlon-Dominczak, 2002).

36. For couples of two high-income earners, it is becoming increasingly attractive to contract out childcare to a third person, where family-based childcare is not available. Other families with two

In individualised pension schemes, an earlier retirement age puts women at a disadvantage, because it discourages them from accumulating pension savings for an equal number of years as men.[37] In combination with an NDC system in the public pension tier, as is the case in Poland, an earlier retirement age is highly detrimental for women, and raises the prospect of significantly increased poverty among future women pensioners.

Some of the differences of perspective among women with respect to social security could be addressed by greater knowledge of social security issues. The country studies are aimed at providing more information and encouraging the sharing of experiences. There is reason to hope that advocates for gender equality will be able to exert more influence further ahead in the reform processes, on the basis of improved understanding of what is at stake.[38] Examining the experiences of countries where reforms are further advanced, such as the ones under study here, will hopefully enable women's organisations in countries at earlier stages of the reform process to be better prepared to participate in pension reform debates.

The outcomes of the study also point at the need for improved awareness about the gender dimensions of reforms among pension experts and decision-makers. This is true both with respect to the gender impacts of reform measures, narrowly conceived, and regarding the controversial and unsettled nature of the topic of gender equality in social security itself. More extensive policy deliberation would hopefully contribute to avoiding unforeseen negative consequences of reforms for gender equality. Further research and debate on reform proposals and enhanced discussion about preliminary experiences with reforms from a gender perspective, are needed as input and background to promoting awareness among decision-makers, experts, and the public at large, about the gender dynamics at play.

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working parents often have to rely on in-family support, most often provided by grandmothers, thus perpetuating traditional role models.

37. Even if women wanted to work beyond their planned retirement age, they might not be able to extend their contribution period. Evidence indicates a great reluctance by employers to hire women close to or past retirement age. See, for example, Petrovic (2002).

38. To contribute to this goal and as a further step in the project on strengthening social security in CEE, the ILO Central and Eastern European Team is currently developing training materials on the basis of the study on the gender impact of reforms, to be used for awareness-raising and education.

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Table 14.1. Do benefit entitlements provide for equal treatment of women and men?

		Poland	Hungary	Czech Republic
1. Retirement age	Pre-reform	no	no	no
	Post-reform	no	yes	no
2. Survivors' benefits	Pre-reform	yes	no	no
	Post-reform	yes	yes	yes
3. Caring credits	Pre-reform	no	no	no
	Post-reform	yes	yes	yes

Source: Author for the OECD.

Table 14.2. Greater individuality in pension rights, selected features after reforms

		Poland	Hungary	Czech Republic
Type of scheme	Pre-reform	mandatory, DB-PAYG	mandatory, DB-PAYG	mandatory, DB-PAYG
Structure of pension formula	Post-reform	mixed, 3 tiers: mandatory, NDC mandatory, FF[1] voluntary, FF	mixed, 3 tiers: mandatory, PAYG, mandatory, FF voluntary, FF	2 tiers: mandatory, PAYG voluntary, FF
	Pre-reform	redistributive DB: flat-rate component, tenure, level of previous wage[2]	redistributive DB: tenure and level of previous wage plus redistribution[3]	redistributive DB: tenure, level of previous income and work category[4]
Minimum pension guarantee after reform	Post-reform	tier I: total amount of paid contributions (indexed) divided by life expectancy tier II: contributions + investment returns – administrative expenses (including annuity purchase)	tier I: DB structure left largely intact, most changes delayed[5] tier II: contributions + investment returns – administrative expenses (including annuity purchase)	flat-rate basic + earnings related component with redistribution[6]
Minimum insurance period after reform		minimum pension after 20/25 contribution years[7] guaranteed minimum return rate (tier II)	means-tested basic pension financed from general revenue[8]	flat-rate portion of the benefit is guaranteed

	Poland	Hungary	Czech Republic
Impact of different life expectancy (women-men)	tier I: for minimum pension guarantee: men: 25 years, women: 20 years tier II: no minimum	tier I: 20 years (up from 10 years), partial pension for service period btw. 10-20 years tier II no minimum	25 years
Redistribution of income after reform	tier I: unisex life tables tier II: no law yet	tier I: no impact of gender differences in life expectancy tier II: unisex life tables	no impact of gender differences in life expectancy
	no redistribution towards low-income earners in either tier	tier I: redistribution gradually decreasing tier II: no redistribution between income groups[9]	redistribution toward low-income earners

1. The Polish and Hungarian systems offer, on a mandatory basis, a purely public as well as a mixed pension option: The first PAYG tier is mandatory for all insured. Membership in the second fully-funded tier is mandatory for all new entrants to the labour market (Hungary) and everybody below age 30 (at the effective day in Poland). Those above 30, but under 50 (Poland), and those already active in the labour market (Hungary), had a choice between the purely public and the mixed path (Müller, 1999).

2. Insufficient indexation (formally introduced in the 1980s only), caused a loss of benefit value (Müller, 1999, pp. 94-96).

3. This formula was in force from the 1970s. Undercompensation for inflation led to a downward trend in absolute and relative benefit levels (Müller, 1999, pp. 61-62).

4. This formula was in force from the 1950s. Pensions were not systematically indexed (Müller, 1999, pp. 128-129).

5. The formula used until 2013 is based on individual earnings and a multiplier that depends on the number of contributory years. Thereafter, the formula will be based on the number of years of service and the average individual monthly earnings up to the ceiling on wages which are subject to the employee contribution. For those in the public pension scheme alone, the pension accrual rate will be 1.65% of average earnings for each year of service. For those in the mixed system, this rate will be 1.22%.

6. Currently, post-1985 earnings constitute the base for pension calculation. The base will gradually increase to 30 years.

7. At age 65 (men) and 60 (women).

8. There was a guarantee that the benefit could not go below 93% of the benefit under the public system, but this was repealed by the Fidesz-led government (1998-2002).

9. There is still some redistribution in favour of women, though, since unisex annuity tables are to be used for benefit calculation in tier II, although women's life expectancy is higher than men's.

Source: Author for the OECD.

Table 14.3. Caring credits in the reformed Polish and Hungarian pension schemes

	Tier I	Tier II
Poland	• leave periods count for minimum insurance period (maximum number of years: 6) • pension contributions during leave periods paid from the state budget • basis for contribution payment: minimum wage[1] (contribution: 12.22%)	• pension contributions during leave periods paid from the state budget • basis for contribution payment: minimum wage (same as tier I) (contribution: 7.3%)
Hungary	• recognition of care leave as non-contributory period • for recipients of insurance-based leave benefits:[2] earnings are credited at level of former wages • for recipients of flat-rate child-related benefits:[3] leave periods raise the number of contributory years, but have no impact on life-time income[4]	• no employer or government subsidy (as with all other second pillar contributions) • basis for contribution payment: level of benefit (contribution: 6%)

1. The minimum wage is the basis in the case of child raising leave. In the case of maternity allowance, it is the level of the allowance (which in turn depends on the previous income).

2. Insurance-based leave benefits are maternity benefit, child-care fee, sick-child benefit and unemployment benefits.

3. For recipients of the flat-rate nursing fee (care for elderly), income is calculated on the basis of the actual benefit, contributions are paid from the state budget on the basis of the amount of the benefit.

4. For benefit recipients who have additional work-related income (from part-time work or home-work), the benefit can boost actual earnings.

Source: Author for the OECD.

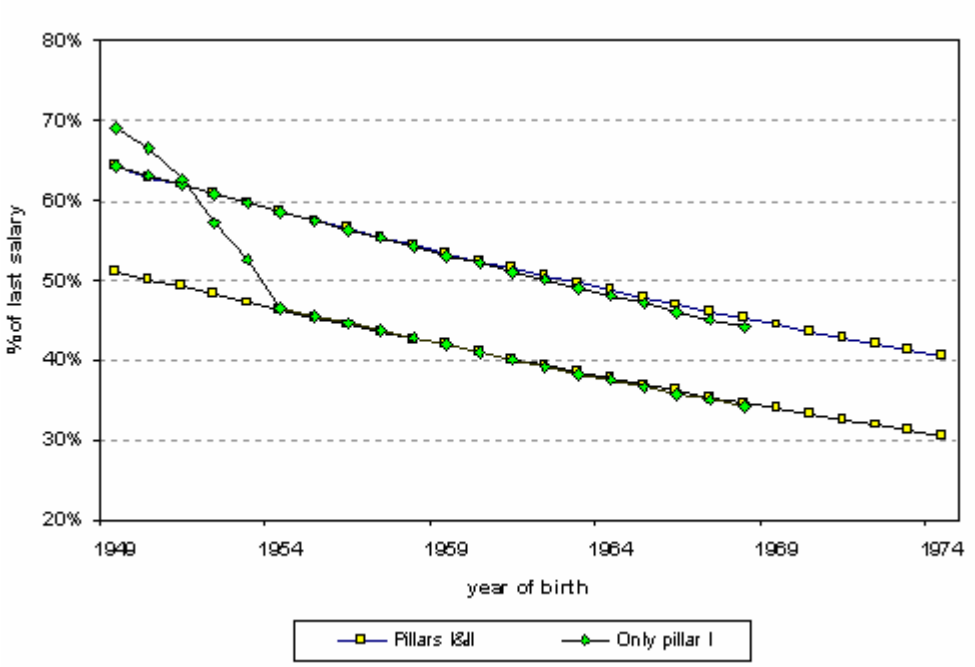
Table 14.4. Projected replacement rates in the old and new Polish systems, % of average wage in the economy[1]

	Typical female		Typical male	
Age	**New system**	**Old system**	**New system**	**Old system**
60	22.4	64.8	30.4	79.5
61	23.6	65.8	32.0	80.8
62	24.8	66.8	33.8	82.2
63	26.2	67.8	35.6	83.5
64	27.6	68.8	37.6	84.9
65	29.2	69.8	39.6	86.2
66	30.8	70.8	41.8	87.6
67	32.5	71.8	44.1	88.9
68	34.3	72.8	46.6	90.3
69	36.2	73.8	49.2	91.6
70	38.3	74.8	52.0	93.0

1. A pension formula using unisex life expectancies is assumed for both pillars in this calculation.

Source: Chlon-Dominczak.

Figure 14.1. Simulated replacement rates for birth groups 1949-1974, women and men, average wage earner, Poland



Note: the upper two lines are for a man, the bottom two for a woman. For assumptions about the indexation of notional accounts and rate of return from tier II, see Chlon-Dominczak (2002), Section 1.3.

Source: Chlon-Dominczak (2002).

PART IV

IMPLEMENTATION OF PENSION REFORM PROPOSALS

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Chapter 15

PENSION REFORM IN POLAND[1]

by
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Origins of reform

Poland introduced a new pension system in 1999. The need for pension reform resulted from high pension expenditures in Poland that peaked in 1995, exceeding 15% of GDP, combined with projected ageing of the Polish population.

The pension system offered relatively high old-age pensions, with the average replacement rate at around 70%. Additionally, the average retirement age was lower than that specified in the legislation, as there were many early retirement privileges offered to some groups of the population. As a result the average male retirement age in Poland was 59 and the average female retirement age was 55.

Demographic projections show that the share of the female and male population aged over 60 and 65, respectively, in the total population would rise from the current 15% to almost 24% by 2030. This is due to the fact that the baby-boom generation is going to reach retirement age during the period 2010-2020. Additionally, Poles are living longer and birth rates are at an historical low.

The combination of demography and of the structure of the old system would have made the Polish pension system unsustainable in the long run. In order to accommodate rising expenditure, social security contributions had been set at a very high level, 45% of earnings, and could not be increased further. The shape of the reformed system was designed to meet the challenges of the demographic situation and make it less vulnerable to changes in the labour market.

In the second half of 1990s, pension reform in Poland was the subject of intense debate among the various actors. The government was not only an actor in this process but also participated as a moderator in the discussions between other institutions and organisations. The debate on the reform ended with the establishment of a special body entrusted with a mandate to prepare the reform programme. In 1997, the reform programme – *Security through Diversity* – was submitted to the government.

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1. This is an extended and revised version of a paper published in *Emergo Journal of Transforming Economies and Societies*, Vol. 9, No. 1, Winter (2002).

Following the presentation of the reform programme the government started to garner support from social partners and the public. The most important *fora* for discussion with the social partners were meetings of the Tripartite Committee. The social partners were given a role in the supervision of the institutions administering the social security system – the Social Security Institute (ZUS), and the Superintendency of Pension Funds. The government also co-operated with unions on the dissemination of the reform concept, training and informing union representatives about the reasons for and the expected outcomes of the proposed new system.

Public relations were an important element in building consensus around the reform. From the beginning of the reform activities, public relations were one of the tools extensively used by reformers. Public opinion polls and focus group interviews helped to test the proposals, and meetings with journalists enhanced the dissemination of information. The press was a forum of discussion between various actors, most importantly between the younger and older generations. The most important goal was to build a large consensus on the reform across various political parties, social partners and generations. It was only in this way that enough support for the reform was generated so as to complete the preparations for and launch the changes in 1999.

The path chosen by Poland was to replace the pay-as-you-go (PAYG) system with a multi-pillar system, with each pillar exposed to the different types of risks affecting the labour and financial markets. Both the first and second pillars are mandatory and operate on a defined contribution (DC) principle. These two obligatory pillars will provide a lifetime pension for all participants. The first pillar is a defined contribution PAYG system with notional accounts (PAYG NDC), whereas the second pillar is fully funded with individual privately managed accounts. The voluntary third pillar will provide an opportunity for higher pensions for those who decide to save more.

The retirement age has been set at the same level as in the old system (*i.e.* 60/65 years). The system offers also a minimum benefit guarantee that would top-up pensions of people with lower earnings and/or shorter working careers. Currently, the minimum pension level is equal to approximately 25% of the average wage. The minimum pension is indexed at the same rate as all pensions, *i.e.* not lower than inflation plus 20% of real wage growth annually.

Social security contributions (including the funded pillar share) are collected by ZUS, which then transfers a part of the contributions to private pension funds. The total contribution rate reaches almost 37% of gross salary (that covers taxes and approximately a half of social security contributions), of which 19.52% serves to finance old-age pensions. The rest covers the risks of disability and survival (13%), work injury (1.62%) and sickness (2.45%).

All insured people born after 1948 are covered by the new system.[2] Those born between 1949 and 1968 could opt for the new two pillar system or for the PAYG alone. Out of this group, approximately 55% decided to join the funded pillar (younger people more frequently than older people).

Structure and sustainability of the new NDC scheme

The first pillar is financed on a PAYG basis but is structured on the new paradigm in social insurance – a defined contribution scheme with notional accounts (NDC).[3] Starting from 1 January 1999, part of the old-age contribution (or full contribution for those who are not members of the funded pillar) is registered in the first pillar account managed by ZUS, which accumulates a notional

2. With the exception of those who accrue pension rights before the end of 2006.

3. For discussion on NDC systems see, for example, Góra and Palmer (2001).

capital. The capital represents the pension rights accumulated by an individual throughout his/her working career. The notional capital accumulated in the account is indexed annually to 75% of the wage bill growth. Indexation below the wage bill growth creates some space to finance the transition period, where pensions are still higher (as a result of past obligations). The NDC benefit formula is based on a standard annuity formula, where the value of the benefit depends on the notional capital accumulated in the account and the period of benefit payment. The main advantages of this approach are:

- Relating benefits to lifetime contributions.
- Higher incentives to comply.
- Higher incentives to postpone retirement.
- Automatic adjustment to demographic changes.

Currently, the contribution rate for financing old-age pensions in the public pillar is set at 12.22% of salary (19.52% for transition cohorts who did not joint the funded pillar). All workers and the self-employed are obliged to pay contributions to the old-age system. Additionally, for some periods, the contribution is financed from public sources (state budget or Labour Fund). These include periods of receiving unemployment benefits, maternity and parental leave, mandatory army service, and taking care of a disabled family member (child, parent). The wage base for calculation of the benefit is either the minimum wage or the size of received benefits.

The pension is computed by dividing the notional capital accumulated on the account by the so-called G-value – life expectancy at the time of retirement. G-values are computed by the Central Statistical Office and are equal to the unisex life expectancy (in months) at the year of retirement. The law does not allow for differentiation of G-values for any reason, such as gender, health status, place of residence, profession, etc.

Pension reform legislation includes a provision that pension benefits should be indexed at least to inflation plus 20% of real wage growth. Such benefit indexation can be viewed from two perspectives. On the one hand it helps to reduce expenditures in relation to GDP, which diminishes the gap between the expenditures and the revenues of the system. On the other, individuals with the same wage and tenure characteristics have different pensions if they retire at different moments in time. Older pensioners have lower pensions than those who claimed their benefits later. In the longer run, such a policy may cause social problems, as happened in Poland at the beginning of the 1990s and which resulted in a re-calculation of all pension benefits to reduce the above-mentioned differences.

The new pension system abolishes all early retirement privileges. All persons born after 1948 and retiring after 2006[4] will retire at the legal retirement age. However, for persons working in special conditions, special arrangements by way of bridging pensions have been proposed. The proposal was discussed with the social partners during the period 1999-2001. Currently, the new government is planning to continue work on this additional element of the pension scheme.

4. With the exception of those who worked long enough in special conditions (20 years), who kept their right to retire earlier.

Transition to the new system

Poland decided to recognise past rights in the form of an initial notional capital, based on the value of the old-age pension accrued on the last day that the old system was in existence (31 December 1998). The initial capital is calculated to deliver the same pension benefit as the old formula (adjusted for age and contributable years),[5] as if everyone retired on the last day of the old system. The formula for the initial capital calculation is:

Initial Capital (C_0) = P_0 * G_{62}, where:

P_0 pension rights accrued by a person as of 1 January 1999

G_{62} unisex life expectancy at the age of 62 in 1998 (209 months)

This approach to the recognition of pension rights was adopted mainly due to the lack of appropriate individual data. In the old pension system, the Social Security Institute received individual information only upon retirement. Because most of the individual records prior to 1980 were destroyed, this method provided a way of dealing with initial notional account status. Also, it allowed for the gradual reduction of replacement rates in the pay-as-you-go system, as the initial capital portion of the notional account decreases over time. Due to difficulties in finding appropriate records, the law sets a period of five years to calculate the initial capital for all contributors in the new pension system.[6]

Figure 15.1 presents the results of the simulation of replacement rates for different cohorts. For the reduction of demographic influence, projected life expectancies as of 2050 are used. Simulations present both values of replacement rates (as per cent of last salary) for a female retiring at the age of 60 (lower series) and for a male retiring at the age of 65 (upper series). There are two variants of the simulations:

a) A worker joins the funded pillar (pillars one and two).

b) A worker stays in the NDC pillar only (only pillar one).

For the average female retiring at 60, the replacement rates gradually decline from around 50 to 30% (excluding the value of mixed pensions for cohorts retiring in the years 2009-2013) and, for the average male retiring at 65, the replacement rate falls from 65 to 40%.

As the simulations show, the decision whether to choose the funded pillar or not, under the given assumptions, has little influence on the total size of pensions.[7] The smaller pension for women can be attributed to a lower retirement age and lower participation rates.

5. For details see Chlon *et al.* (1999).

6. Additionally, during the transition period, the first five cohorts to retire under the new system will receive their pensions according to another transition rule. Pensions granted in the years 2009-2013 will be calculated according to a weighted average of the old and new pension formula. This formula applies to those women who will not participate in the funded pillar.

7. The key assumptions are: the annual average wage growth is 4%; the annual notional accounts indexation is 3.8%; the gross rate of return in the funded pillar is 4.2%; and fees on the funded pillar equal the current average for the sector.

The PAYG system in the longer term[8]

In this section, long-term projections related to the pension system are presented. Projections are made using the Social Budget Model.[9]

While analysing the long-term impact of pension reform on the finances of the pension system, it must be realized that there is a difference between the impact of the reform on the revenues of the old-age pension scheme in the transition to the multi-pillar system and its impact on the expenditures. The impact on revenues starts immediately the funded scheme is introduced, as part of the contribution is diverted to savings. Upon introduction, the most important issue that pension systems face is financing the transition deficit. Such a deficit can be financed from current revenues of the state budget (taxes or extraordinary revenues such as privatisation assets), which means that it is financed by current tax-payers (most notably workers and pensioners). It can also be financed by issuing special bonds – in that case, the transition is financed by future taxpayers. Finally, the deficit can be financed by savings in the PAYG pension system and in such cases pensioners are burdened with the cost of transition. The way of financing transition costs has an impact on the relative wealth of various generations.

Under the reform programme in Poland the transition costs will be financed initially from privatisation revenues and from the state budget (current taxes or debt). As simulations in Chlon-Dominczak (2002) show, in longer term however, most of the costs will be covered by the reduction of expenditure made in the public (NDC) pension system.

In the case of the benefit payout phase (*i.e.* pension expenditure), the impact of pension reform starts later. The actual timing of expenditure depends on the age of the cohorts covered by the reform regulations. In the Polish case, people under the age of 50 at the time of the introduction of the reform were covered by the new system. This means that the impact of the new regulations will be observed when this group starts to reach retirement age in 2009, in the case of women and in 2014, for men. By the same token, until 2009 all pensioners will receive pensions based on the old system formula. After this date, new system pensions will begin to be granted. The transition in the pensioners' portfolio is going to take decades.

The reform of the pension system, due to the changes in the eligibility criteria and the pension formula that it introduced, is having a significant impact on the overall situation of the pay-as-you-go pension system. Firstly, as the retirement age is increased, it is expected that the number of pensioners will be lower compared to the pre-reform situation. Secondly, the replacement rate resulting from the pensions granted under the new pension formula will be lower than that in the old pension system. These changes will result in a reduction of expenditure on old-age pensions. On the other hand, the revenues of the system are reduced due to the contribution transfer to a funded tier.

According to the projections in Chlon-Dominczak (2002), under baseline assumptions, public expenditures on old-age pensions will go down from around 6% of GDP currently to around 2% of GDP in 2050. The expenditure reduction should continue until 2040 and stabilise afterwards. The deficit in the old-age part of the system, according to this simulation, should persist until 2025. Afterwards, a surplus should appear reaching 1.4% of GDP in 2050.

8. This section comes from Chlon-Dominczak (2002).

9. The Social Budget Model was prepared by the Gdansk Institute for Market Economics, in co-operation with the Ministry of Labour and Social Policy in Poland and with the ILO.

However, if all pension expenditure is taken into account (including disability and survivor pensions), projected pension expenditure will reach 9.65% of GDP in 2050. For almost the entire projection period, all pension expenditure from the Social Insurance Fund will fluctuate at a level between 9% and 10% of GDP (compared with pension expenditure in 2050 equal to 17.3% of GDP in the no-reform scenario). For the entire projection period all pension expenditure (old-age, disability and survivors) will be higher than contribution revenues, resulting in an annual deficit of around 2% of GDP.

The costs of the introduction of the funded tier are higher than the deficit encountered in the old-age pension part of the system, as can be observed in Figure 15.2. By 2005 the total deficit in the public old-age pension scheme will be lower than the amount of contributions transferred to pension funds, that is, rationalisation measures introduced in the public system (initially mostly benefits' indexation) will partially finance the transition to the funded scheme. Figure 15.3 presents the decomposition of old-age pension expenditures by the source of financing. The share of the public system (the old system and the reformed NDC one) will dominate expenditures throughout the projection period. However, the relative size of the old part will decrease. By the mid-2020s, the share of the old system as part of total pension expenditure should be less than 50% and by 2050 it should be marginal. In 2050, the bulk of pension expenditure will still be financed from the public system as by that date the funded tier will finance only around a third of pension expenditure.

There are two factors that influence the size of expenditures: the number of beneficiaries and the size of the average pension. Within the projection period, the number of old-age pensioners will increase, until it exceeds 4 million in 2020. Thereafter, a decrease in the number of old-age pensioners is expected, to the level of 3.4 million in 2035. As a result of the retirement of the baby-boomers born in the 1980s, the number of old-age pensioners will increase again to 4 million in 2050. Compared to the no-reform scenario, the number of old-age pensioners in 2050 is projected to be 6 million fewer.

The reduction in the number of old-age pensioners will be off-set by the rise in the projected number of disability and survivor pensioners, as the increase in retirement age will cause an expansion in the number of persons claiming disability pension. The results of a simulation in relation to this issue show that the number of disability pensioners is going to increase to 4.3 million (compared to 2.3 million in the no-reform scenario) and the number of survivor pensioners will exceed 2 million (which is slightly higher than in the no-reform scenario). The projected number of pensioners and the transition between the old and the new systems are shown in Figure 15.4. Pensioners receiving their benefits based on the rules of the old system will be in the majority until mid-2020s, which corresponds to the expenditure decomposition. Thereafter, the share of "new" old-age pensioners will increase. By the end of the projection period, practically all old-age pensioners will be receiving new benefits.

In the case of pensions granted under the old system, the replacement rate should decrease from the current level of more than 60% of wages to around 35% by 2050. Such an erosion is related mainly to the assumed rate of indexation of pensions, which is equal to price inflation plus 20% of real wage growth (which is currently the law as set out in the law on pensions from the Social Insurance Fund). During the first years of the projection, the reduction is smaller, as newly granted pensions influence the average level. After 2009, when pensions are granted according to the new rules, the drop will be faster.

In the case of the new system, the projected value of pensions is much lower than the value of loans provided under the old scheme. Lowering the value of benefits by making them actuarially neutral was one of the goals of the reform plan. Such a policy, however, may lead to increased poverty among pensioners. As a result, savings in the pension system would be accompanied by increased

expenditure on social assistance for pensioners. Thus, in the future, a balance between the macroeconomic stabilisation of the pension system and providing pensioners with decent income should be sought.

The complementary role of other pillars

In this section the structure and performance of the two remaining parts of the pension system is described. It includes the mandatory funded pillar (the so-called second pillar) and voluntary funded plans, sponsored by employer – employee pension plans, which represent a part of the third pillar of the new pension scheme in Poland and which is regulated by the law on employee pension plans.

Second pillar

The second pillar is based on savings placed in obligatory open pension funds. The contribution rate to the second pillar is equal to 7.3% of a worker's wage. Funds are privately managed and the contribution is invested into financial market instruments. Pension funds in Poland are set up in the form of private joint-stock companies. They are managed by separate entities – Pension Fund Societies (PTEs), which are also private joint-stock companies. Institutions that are shareholders of the PTEs are usually financial market institutions (such as banks or insurance companies), both Polish and international. Regulation of the funded pillar in Poland was aimed at creating a transparent system, where pension savings are separated from the assets of managers and cannot be misused in any way. Pension funds and pension fund societies are also supervised by a public institution – the Superintendency of Pension Funds (UNFE). All its regulatory functions are geared towards protecting members' interests. In its activities UNFE co-operates with other governmental institutions, such as the National Bank of Poland, the Social Security Institute, the Polish Securities and Exchange Commission as well as employers' organisations and trade unions.

Each PTE can manage only one fund. It is important that pension funds and pension fund managers are separate legal entities. Such arrangements allow for a clear distinction of the assets belonging to each pension fund, and which are owned by the pension fund members. After retirement, according to the reform programme, the retiree will be required to buy an annuity. Annuities are to be provided by specialised annuity companies.[10] According to estimates, for the average wage earner, the pension from the funded pillar (under the assumptions shown in Figure 15.1) can range from 10% of his/her final salary (for persons retiring at age 60) to 13% (for persons retiring at age 65) in the case of persons who start contributing under the new regulations.

The guarantee system in Poland for second pillar funds includes the following elements.[11]

- Regulations on investments – selected financial instruments and maximum limits on investments.
- Separate custody of a pension fund's assets by large banks operating in Poland.
- Requirement of a minimum rate of return, which cannot be lower than half of the average rate of return for the pension fund market (calculated quarterly for the preceding 24 months).

10. According to the draft annuity law submitted to the parliament. At the time of writing, the parliamentary debate on the law was not finished and the final solution may differ.

11. For a full description see Chlon *et al.* (1999).

- Reserve fund (1.5% of a pension fund's assets), which is activated in the case when the investment return of a pension fund is lower than the required minimum.

- Guarantee fund, financed by all PFS, managed by the Central Depository. If the PFS does not have enough sources in its reserve account and from its own capital to pay the deficit, member's savings are replenished from the Guarantee fund. Total assets of the Guarantee fund should not exceed 0.1% of the total assets of the pension funds sector.

Annual revenues of the sector are projected to increase from currently about 1.5% of GDP to almost 2% of GDP after 2020. At the same time, expenditures will be much smaller, especially in the first 20 years, when they should not exceed 0.5% of GDP annually. A significant increase of expenditures is projected after 2025, when most of the pensioners start to receive their funded pensions (Figure 15.5).

In 2050, the projected size of assets accumulated in the funded tier should reach the level of 180% of GDP.

Third pillar

The pension legislation envisaged the third pillar is voluntary, based on individuals' savings or employer-sponsored programmes. During the reform preparation, the latter – so-called employee pension plans – received the greatest attention. The law envisages that employers may sponsor such plans for their employees in one of the following forms:

- An employee pension fund.
- Agreement with an investment fund.
- Mutual insurance; or
- Agreement with an insurance company.

Employers may pay up to 7% of salary to such a programme. The contribution is taxable, but it is not subject to a social security contribution, which creates some savings for both employers and employees. Savings accumulated in such plans may be withdrawn only after a participant reaches the age of 60 (regardless of gender) or earlier, if he or she becomes disabled.

Pension plans are registered and supervised by UNFE. As of the end of 2001, there were more than 100 employee pension plans registered with UNFE. Those plans cover a very modest share of the labour force in Poland. Employers' interest in establishing employee pension plans is limited due to several factors:

- Relatively complicated registration procedures.
- Already high labour costs.
- The difficult situation in the labour market and the lack of incentives for employers to establish long-term plans with uncertain prospects for the future; and
- No fiscal incentives.

Efforts are being made to enhance the development of the third pillar, mainly by simplifying the registration procedures.

Implementation of the reform

Reform implementation and the individualisation of contribution payments created a challenge for all the institutions involved – ZUS, employers and banks. The short time after the enactment of the reform legislation and its implementation (approximately a couple of months) and delays in the development of ZUS IT systems, made the implementation process even more difficult.

First experiences revealed many problems in the proper identification of payments. As a result, changes in the law were necessary. The first test of the new system – the transfer of the first contributions to private pension funds – showed that only 5% of payments had been properly identified.

In the course of 1999-2001, the social security law was amended 17 times. Some of the amendments were related to the development of legislation in other sectors and some were initiated by the Ministry of Labour and ZUS in order to solve problems and issues that emerged during the implementation.

Legislative changes during this period included, among others:

- Improvements in the identification of insured people by obliging employers and pension funds to use two identification numbers: PESEL (a registration number) and NIP (a tax number).

- The introduction of an annual report for all employers in 1999-2001.

- A shift in the dates of contribution payments and reports delivery. The change allowed for partial elimination of a "peak time" in the delivery of reports to ZUS offices and permitted more time for document correction and analysis.

- The introduction of a penalty fee for those who made mistakes in monthly reports or bank documents.

- The stipulation that employers who employ more than 20 staff should submit data electronically, as electronic transfer generates the smallest number of errors.

Amendments to the legislation also postponed the deadline for sending the first report on their accounts to insured persons. Under the reform, each insured person must receive an annual statement of his or her notional account. As the implementation of the computer system was delayed, the date for issuing the first such statement was moved to August 2002. Changes in the legislation were accompanied by administrative reforms in the Social Security Institute.

The way ZUS was organised and managed had to be improved in order to keep up with the changes introduced by both the social security and the health insurance reforms. Although much had been done in order to prepare ZUS for its new role (mainly preparation to service the second pillar private pension funds and health care funds), more profound changes were needed and quickly. In order to prepare ZUS for change, a strategic plan was developed by the end of 1999.

The development of the Strategic Plan was facilitated through a series of sessions involving all members of ZUS top management. The participants of the strategic planning process agreed on five strategic goals:

1) To improve ZUS performance in the realisation of its statutory tasks.

2) To identify and improve upon customer satisfaction.

3) To increase internal efficiency.

4) To enhance effectiveness of human capital in ZUS.

5) To increase ZUS ability to adapt to change.

Throughout the project, much emphasis was placed on evaluating the efficiency of operations of ZUS local branches. The recommendations that resulted from the analysis of such evaluations helped develop a new organisational structure within ZUS and improve the way the institution operated.

Development of the computer system in ZUS

After the implementation of the reformed system and of the obligation to transfer part of the contributions to open pension funds, an interim IT system was initially created so that monthly information could be processed in a simplified way. However, this system was not sufficient to support either the correction of errors or the maintenance of the individual accounts. After 2000, most efforts were focused on completing the main component of the IT system, namely the Registry of Accounts and Funds (SEKIF). At the end of 2000, the mainframe computer was successfully installed in ZUS. From August 2001, all current contributions were registered on individual accounts on the final platform (however the interim system was still used to transfer second pillar contributions). The IT system began operating in its final form from June 2002, when the final platform achieved a greater level of efficiency in information processing than the interim one.

Currently, the main focus in the development of the IT system is on improvements in the quality of the data in the monthly reports and on processing documents for 1999-2001 so that contributions are cleared of errors and registered on individual accounts. This should also enable ZUS to assess arrears in the pension funds.

Initial capital

In the second half of 2000, after the relevant decree came into force, ZUS started to collect the information necessary to calculate the initial capital, representing accrued pension rights on the notional accounts of insured persons. This requires gathering necessary historical data on wage and employment history for all persons covered by the pension reform.

The process is complex and requires action not only by ZUS, but also by employers, who need to submit necessary documentation, and by insured persons who are obliged to collect documents from their previous workplaces. The law requires that the process should be finished by the end of 2003.

Contribution transfer to second pillar

Currently, according to ZUS estimates, 80% of contributions are transferred to pension funds. The rest is not sent on, mostly due to lack of accompanying information that would enable it to be appropriately transferred. The other problem is that of dormant accounts, where the members of pension funds are either not insured and do not pay contributions or are not properly identified in the ZUS databases. For those persons no contribution at all has been transferred to pension funds. As of

the end of 2001 some 20% of accounts had not received any contribution. This share varies from fund to fund, ranging from 8% to 77%.

In the period of 1999-2001, more than PLN 18 billion of contributions were transferred to pension funds. The transfer was smallest in 1999 (almost PLN 2.3 billion). In 2000 it was more than PLN 7 billion and in 2001, almost PLN 9 billion. In the following years the transfer should increase slightly with the growth in wages and in the number of pension funds participants (Table 15.1).

It was assessed by ZUS that at the end of 2001, the total debt to pension funds resulting from delays in contribution transfer was more than PLN 7.3 billion, of which contributions accounted for PLN 5.5 billion and interest for PLN 1.8 billion. It is planned that the arrears owed to pension funds will be financed in the form of special bonds issued by the state budget.

Conceptual work on missing components of pension reform legislation

Bridging pensions

The Ministry of Labour and Social Policy is working on the draft legislation for bridging pensions, compensation mechanisms and retraining that is intended to replace the early retirement privileges existing in the old pension system. The work of the Ministry is based on the report of the Medical Experts Committee for Assessment of the Rights to Lower Retirement Age of Persons Employed in Special Conditions or Special Character. The Committee specified types of occupations that would enable persons who currently perform this work to draw a special type of benefit called a bridging pension. Based on the Committee report, the Ministry of Labour submitted the bridging pensions law proposal to the social partners in 1999.

Under the government proposal, bridging pensions would be financed by the state (for the period until the bridging pensions law is legislated) and employers (for the period after the bridging pensions law is enacted). Individuals currently working under special conditions will have a right to a bridging pension. Contributions would be set and collected by the Bridging Pensions Agency, which is going to manage the Bridging Pensions Fund (FEP). External asset managers, selected by tender will manage the assets of the FEP. The Bridging Pensions Agency will also pay benefits. Those persons that had early retirement rights under the old regulations and are not covered by a bridging pension will receive compensation in the form of increased initial capital in their pay-as-you-go pension account.

The conceptual work on the bridging pension is continuing and within the next couple of years the legislation should be completed.

Annuity legislation

The accumulation phase of participation in the second pillar is fully regulated by laws already introduced. The contributions for the second pillar part of the old-age pension are paid into open pension funds that are managed by pension societies through the financial markets. However, regulations concerning the benefit phase are incomplete. There are three possible options for providing annuities currently being discussed:

- Specialised annuity companies – privately managed and competing with each other. The first government proposal was based on this idea. However, after further consultations, the government had reservations about this arrangement because of the relatively high costs and difficulties in calculating annuities based on unisex life expectancy (which was preferred by all political parties in the previous parliament).

- Allowing life insurance companies to deliver annuity products. Such a solution would mean relatively low start-up costs and combining reserves for life insurance and annuity products. However, it is still relatively costly and leads to a situation where the mandatory pension system loses part of its transparency.

- One annuity company pooling risk and contracting out management of assets based on investment performance. Such an option allows for better risk pooling and relatively easy use of unisex life tables. It would also keep the costs low. However, it does not allow individual choice and might be subject to political risk.

The new system covers workers born after 31 December 1948. This implies that the first annuities will paid out from 1 January 2009 (women's retirement age is 60). Men will start retiring from 1 January 2014. Whatever the option chosen, appropriate institutions will need time to "warm up". Although there is still time to design and set up one or more institutions to provide annuities, the appropriate legal measures should be taken sooner rather than later.

National actuary

The main goal of the pension reform in Poland was to create a pension system that is financially stable in the long run. Such a goal cannot be achieved through one measure alone – a change in pension legislation. Thus, the establishment of a National Actuary, whose responsibility would include the provision of long-term actuarial estimates of the revenues and expenditures of the social security system, seems to be crucial. According to the original idea, any change in the legislation affecting the financial situation of the social security system would have to be accompanied by a report from the National Actuary. The Actuary would also publish regular reports on the long-term outlook of the social security systems and would serve all public institutions in matters related to actuarial analyses, similar to the Government Actuary in the United Kingdom. The National Actuary would head a separate Agency. This institution should be fully independent and all its reports should be based on professional assessments made by the National Actuary. Therefore, the post of National Actuary should be given to a person with the highest professional qualifications.

Development of the mandatory funded pillar of the system

As many as 21 pension funds started their operations in Poland in 1999. By the end of 2001, 17 pension funds and PTEs remained in the market, and four were liquidated as a result of merger and acquisition processes. Total assets of pension funds reached the level of PLN 20 billion (around USD 4 billion), which was almost double the figure for the year before (see Figure 15.6).

There were 11 million registered members of pension funds. For more than 9.5 million of these, at least one contribution was transferred. Annual inflow of contributions (as projected for 2002) is around PLN 11 billion(about 1.5% of GDP).

The market is concentrated. The share of the three biggest funds measured as a share of the total assets amounts to 65% and measured as a share of the membership – exceeds 55% (Figure 15.7).

The investment portfolio more or less stabilised after the fourth quarter of 1999. On average slightly above 60% of assets is invested in government bonds, while around 30% is invested in assets. The remaining share is invested mostly in treasury bills and other instruments (Figure 15.8).

Performance during the first three years of operation shows that pension funds in the first two years outperformed the benchmark, while in 2001 they under-performed. Generally, the performance

in 2000 and 2001 was seriously influenced by the worsening situation of the financial markets, especially in 2001, when the Warsaw Stock Exchange bluechips index (WIG-20) was reduced by a third.

The performance of pension funds in the first three years, combined with the structure and level of pension fund charges, resulted in negative net rates of return for their first two years of operation. However, in the following years, as charges in relation to assets will go down, members can expect positive returns on their pension fund savings (Table 15.2).

Summary

The implementation of the pension reform in Poland provides valuable lessons for other countries. The reform concept envisaged the creation of a system that would be financially sustainable and transparent. The most important feature of such a system was the creation of a very strong link between contributions and pensions – both within the PAYG and funded pillars of the new multi-pillar scheme.

The first months of implementation showed that not enough effort was put into the development of a proper administration for the new scheme. Individual accounts were not created until mid-2002 and only a fraction of contributions was transferred to open pension funds. The funded pillar (despite lower transfers) developed more smoothly. Moreover, massive advertising and sales campaigns by pension funds left an impression that the new system would provide people with significantly higher pensions that currently paid.

Such an impression, as projections show, might be misleading, as the contributions paid into the system would grant benefits, which in relation to wages, would be lower than currently paid. Only if wages increase significantly will future pensions be higher in real terms than current ones.

The experience of Poland shows that reforming the pension system is not a one-step action. Rather it is a long process that requires a lot of preparation and extensive monitoring even years after the implementation of the change. For the success of this process all the necessary components – preparation of the concept, consultations, legislation and finally implementation – must be carefully planned, and all possible scenarios have to be considered.

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Table 15.1. Transfer of contributions to open pension funds

	Contributions and interest	Contributions	Interest	Amount of transferred contributions	Average contribution per pension fund member	Average salary base per pension fund member
	In PLN million					
Total	**18 595,91**	**18 502,01**	**93,90**	**168 790 965**	**109,61**	**1 501,57**
1999	2 285,54	2 262,67	22,86	23 346 432	96,92 zł	1 327,63 zł
2000	7 603,49	7 586,39	17,10	70 517 118	107,59 zł	1 473,73 zł
2001	8 706,88	8 652,94	53,94	74 927 415	115,49 zł	1 581,98 zł

Source: ZUS.

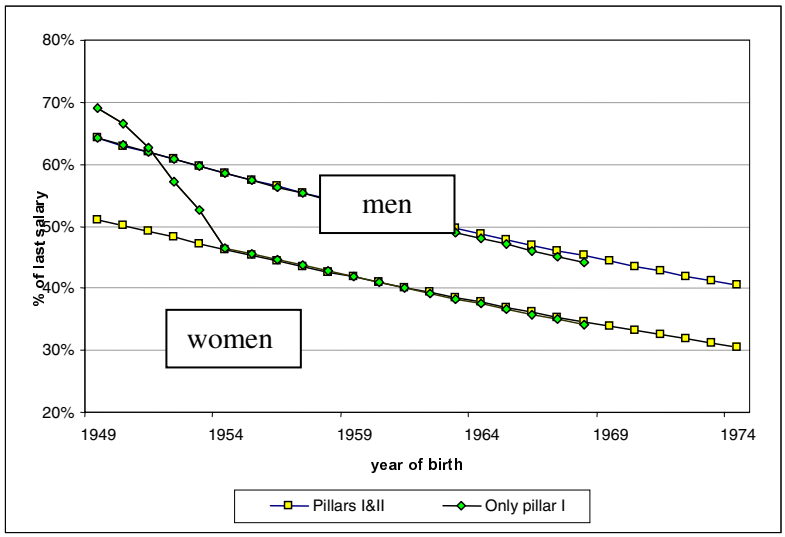
Table 15.2. Performance comparison of pension funds in Poland

	1999*	**2000**	**2001**
Benchmark**	5.31%	7.40%	8.21%
Weighted average	15.09%	13.03%	7.06%
Mean	15.86%	14.27%	4.85%
The best pension fund	20.50%	18.30%	10.03%
The worst pension fund	12.40%	765%	-4.26%
WIG-20 Index	17.08%	3.44%	-33.47%
Inflation	5.10%	8.61%	3.65%
Fixed Income Benchmark	1.83%	10.03%	23.64%

* 20 May-31 December 1999

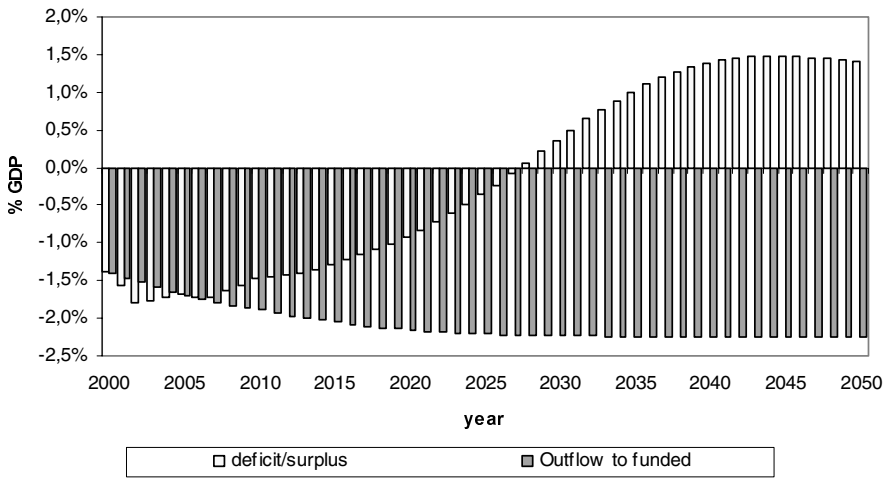
** Benchmark – 30% equity, 70% fixed income

Figure 15.1. Simulated replacement rates for birth cohorts 1949-1974



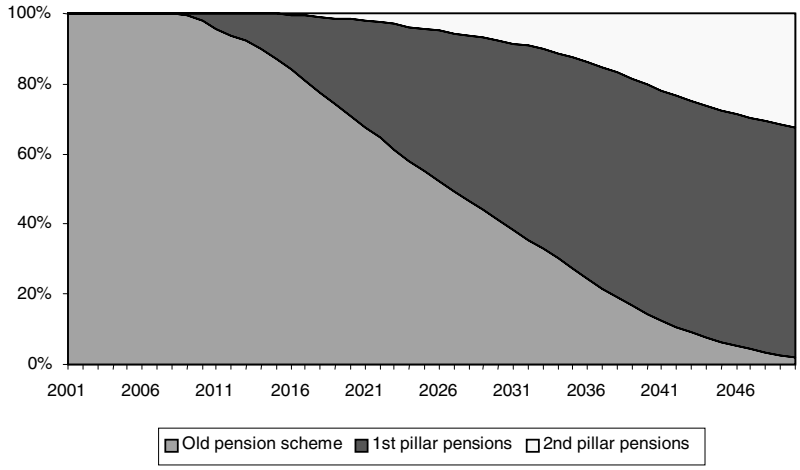
Source: Author's calculations.

Figure 15.2. Outflow to funded tier vs. deficit/surplus in pay-as-you-go



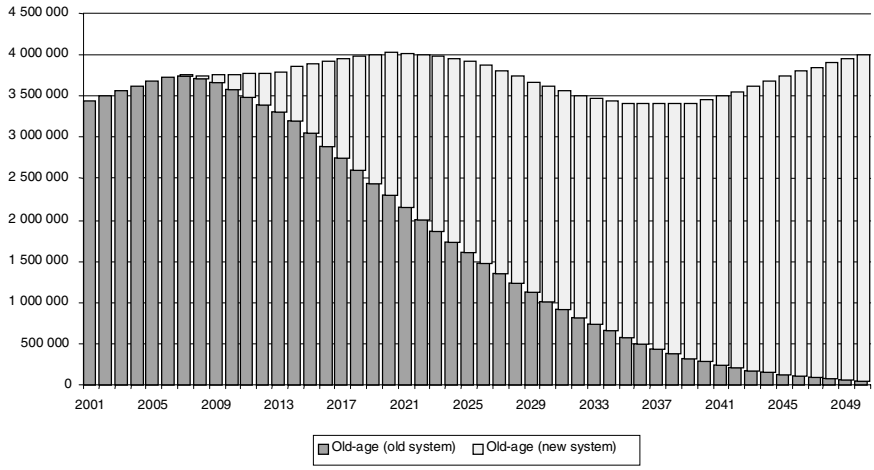
Source: The Gdansk Institute for Market Economics, Social Budget Model, Model after Chlon-Dominczak (2002).

Figure 15.3. Financing of pensions, 2000-2050



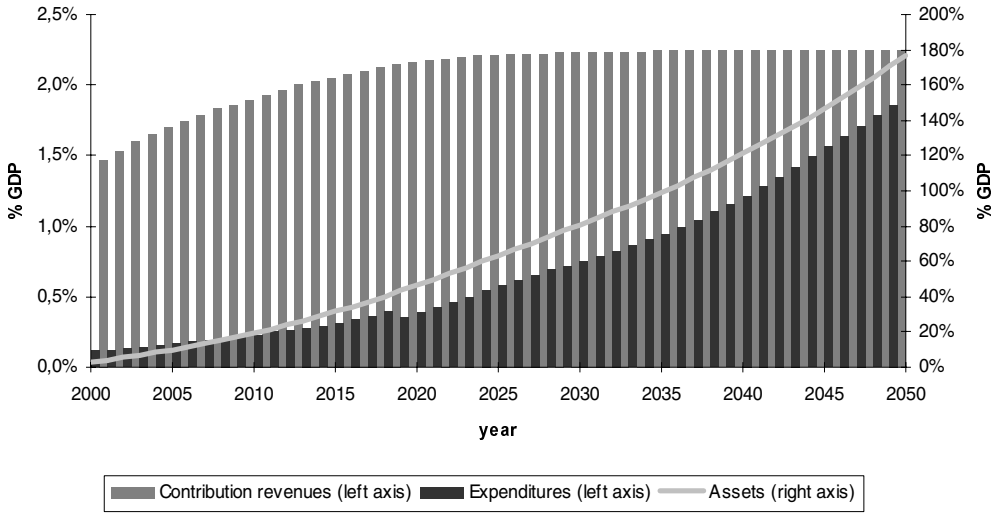
Source: The Gdansk Institute for Market Economics, Social Budget Model, Model after Chlon-Dominczak (2002).

Figure 15.4. Projected number of old-age pensioners, 2001-2050



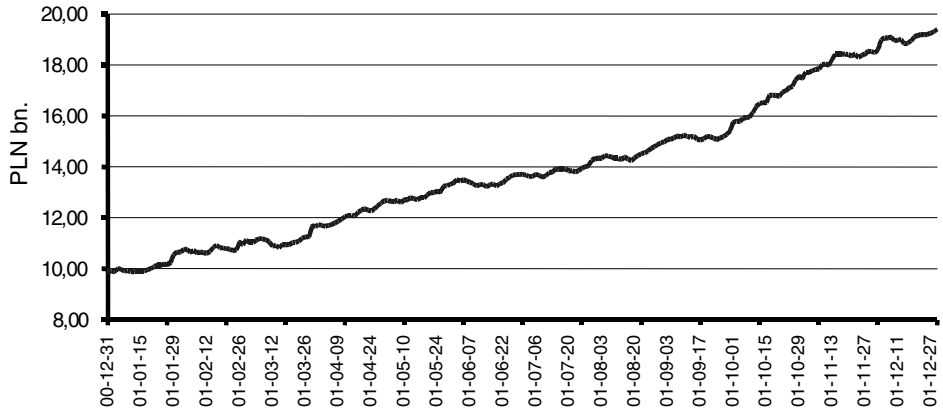
Source: The Gdansk Institute for Market Economics, Social Budget Model, Model after Chlon-Dominczak (2002).

Figure 15.5. Revenues, expenditures and assets of pension funds, 2000-2050



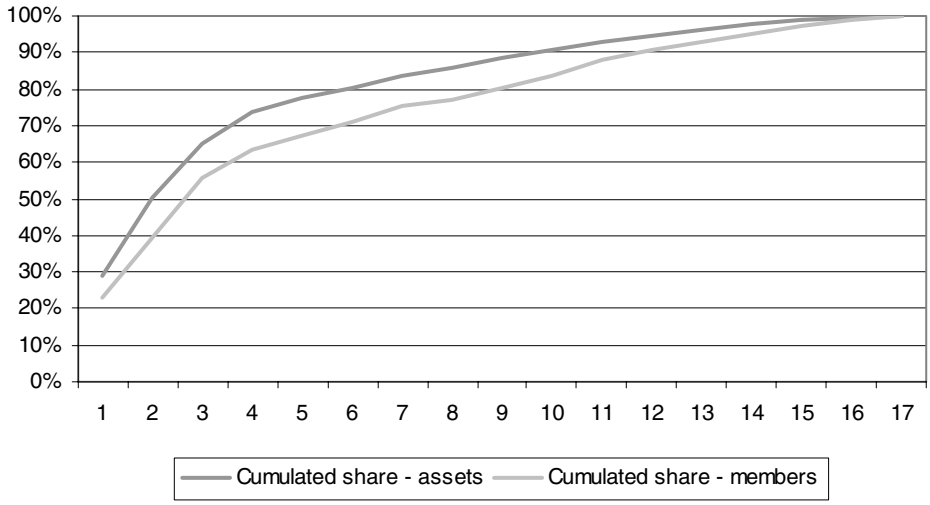
Source: The Gdansk Institute for Market Economics, Social Budget Model, Model after Chlon-Dominczak (2002).

Figure 15.6. Net assets of open pension funds in 2001.



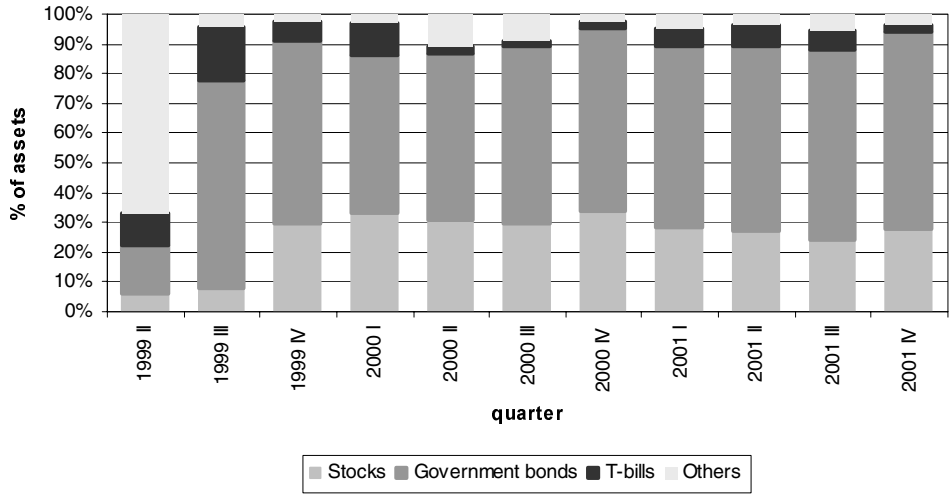
Source: UNFE

Figure 15.7. Concentration of pension funds market



Source: UNFE, data as at 31.12.2001.

Figure 15.8. OFE's investment portfolio structure, 1999-2001



Source: UNFE.

Chapter 16

SOME PRACTICAL ISSUES IN THE HUNGARIAN PENSION REFORM

by
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Introduction

In practice, people often mean only one part of a pension system when discussing pension reform, that is, the changes made to a social security system. However, a systematic approach requires a broader discussion.

A pension may be defined as the regular income granted for life after retiring from work at a certain age, on the basis of rights obtained during the years spent at work. But in a broader sense, any income can be considered as a pension if it ensures a certain standard of living in old age, the inactive life phase. Thus, all institutions that provide such pensions can be considered as elements of the pension system.

One of the most important features of the Hungarian pension reform was that new institutions were established to provide pensions supplementing and complementing government social security pensions. In the past, the only institution providing pensions was the so-called social security institution. But the Hungarian reform has created what are essentially new institutions. These are private organisations, operating on a defined contribution basis. This form of individual provision as well, as the concept of pension planning, was totally new in Hungary. As a result, the very first reactions to these new institutions were negative, as people were afraid of losing the stable state provision, which had provided an income almost independent of an individual pensioner's past employment record. The first task for the new institutions managing pension funds was to gain people's confidence.

Together with these new pension institutions, a three pillar system was built up in Hungary. The first pillar is the pension granted by the social security agency. The second pillar consists of pensions paid by mandatory private pension funds that are built up from mandatory contributions set as a proportion of wages. The third pillar includes pensions that are provided on the basis of pension fund contributions or insurance fees, paid voluntarily by the insured person or their employer.[1]

1. The usual meaning of the three pillars of state/occupational/personal pensions is different from the Hungarian interpretation of the three pillars. Sometimes this has resulted in some misunderstanding, as the second pillar in Hungary means the private mandatory system, which is different from the more traditional meaning of the second pillar in Europe, namely occupational pensions.

This paper deals with some aspects of the private pension system as a whole, but of course the mandatory system is its main focus.

The pension promises in the mandatory system

There was extensive debate, motivated by different political views, on the reform of the mandatory system. Many arguments were made for and against the reform, and many details of the final legislation were influenced by these debates.

The answer to the question whether it is worthwhile for individuals to join the new two pillar system (that is, to join the second pillar as well as belonging to the first) was given by the citizens of Hungary, of whom a far higher proportion voted to join than was initially projected. But this vote was not really consciously for the new system, but rather against the old one. The low level of state pensions, the lack of transparency, and some types of social injustice in the old system were widely known at the time of the vote.

Taking into consideration the pension promises of the two different mandatory systems, it should be realised that the advantages of the new system can only occur where there is good investment performance, providing a positive average real rate of return. Thus it is not clear that all those who joined the two pillar system will eventually receive better pensions than those who remained in the state system alone.

The development of the private pension fund market

When voluntary pension funds began to operate, the majority of interested parties were hesitant. This may have been due either to lack of information or because of distrust, but in essence the majority of people did not really know how to take advantage of this new institution. Even those with available disposable income became interested in investing in these pension funds only slowly. Only a few corporate employers made strategic decisions to supplement employees' pensions, as the uncertainties of these years of change meant that the focus of corporate decisions was not on long-term strategic considerations. Thus, the number of members of voluntary funds increased only gradually. In practice, only the opportunity for tax savings motivated the interest of employers and employees in voluntary pension funds.[2]

The establishment of mandatory private pension funds from January 1998 was a real turning point. The introduction of the new mandatory pension system raised new issues such as individual responsibility, contributing to a pension that was not guaranteed by the state and the potential risks to living standards in old age. The creation of the second pillar forced the majority of employees – those below retirement age − to decide within a very short period of time (from a historical point of view)[3] whether to enter the new, mixed insurance system or to stay in the traditional social security system. And if they decided to enter the former, they also had to decide which mandatory private pension fund they wished to join. Young entrants also faced this latter decision, as although the act made entry

2. Between 1995 and 1999, 50% of the contributions (up to a maximum of HUF 200 000 per year) paid into voluntary funds were tax deductible. This meant a net tax saving for people paying membership fees, since the marginal tax rate was lower, even in the highest tax bracket, than the amount of tax relief. In the first two years, even more favourable tax laws were in force. After 2000, tax relief decreased to 30% of payments, but the employer's contributions became tax-free up to a determined amount.

3. The law only provided employees below retirement age with the opportunity of entering one of the private pension funds until the end of 2000.

mandatory for them, the freedom to choose which fund to join remained. As a result, most employees were forced, at some level, to deal with the issue of their pension provision.

Many people were afraid that the development of mandatory private pension funds would slow down the growth of voluntary funds, or even undermine them. But this did not happen. Indeed, the development of voluntary funds was further accelerated by the improvements in mandatory private pension funds, since it then became clear that voluntary funds were not only a means of tax saving. In fact, this concern could not even be justified theoretically by the voluntary funds, since the target groups of the two different types of pension funds were also different. Mandatory private pension funds are primarily an alternative approach for younger people, while entering voluntary funds can be a form of saving worth considering by individuals who are closer to retirement.

By the beginning of 2000, the Hungarian pension fund business had developed into a real industry. Figures show convincingly that the story of the Hungarian pension fund "industry" is a success. By the end of 1999, of the almost 4.1 million economically active members of the Hungarian population, more than 2 million had entered into one of the 32 registered mandatory private pension funds. The number of members of voluntary private funds also exceeded 1 million. By the end of 1999, the assets handled by private funds were near to HUF 250 billion. It is also significant that by 1999, pension fund savings represented 5% of total household savings, while this figure was less than 1% in 1996.

High levels of concentration can be observed in both the mandatory private pension fund and the voluntary fund market. Concentration is especially high in the mandatory private pension fund market. According to data for the end of 2001, of the nearly 2.25 million fund members, about 90% belong to the largest six funds. Membership of each of these funds has reached 100 000 persons, and these six funds possess assets that represent about 80% of all mandatory private pension fund assets.

Concentration is somewhat smaller in the voluntary fund market, but the concentration process is becoming increasingly marked. Of the approximately[4] 240 voluntary funds registered at the end of 1999, the 18 largest had almost 72% of the membership, and the 27 largest funds at the end of 1999 had nearly 70% of the total assets. At the same time, of the almost 300 voluntary pension funds established in the last five years, fewer than 150 funds remained by mid 2000, and fewer than 110 by the beginning of 2002. Since fewer than 5% of the established voluntary funds had a membership of 5 000 persons or more, in many cases the termination of funds arose from basic economic pressures. But the evolution of the current size structure cannot only be accounted for by this factor alone.

The information gap

In the process of Hungarian pension reform, probably the biggest mistake was that the state failed to fulfil its obligation to inform citizens fully about it. There were several attempts at organising appropriate information campaigns, and different types of support were available for these. Still, these campaigns were either inefficient, or information provision initiatives were simply not implemented. As time passed and the deadlines determined by the law expired, citizens interested in ensuring their pension security were left to make their decisions with inadequate information. Indeed, as the intentions of the government itself, in respect of pension reform, were contradictory, uncertainty amongst its citizens as to the appropriate course of action to take only increased conflicting political interests made the process of pension reform – of which people were already distrustful – less and less

4. The exact number of voluntary funds at a given date cannot be precisely determined, partly due to fusions and mergers in process, reported or under preparation, and partly because of the existence of funds that are not yet actually operating or else have gone out of operation.

credible. It was obvious that the nature of the communication about this subject by the government with its citizens was inappropriate. It was not even clear whether the government wanted the pension reform to be successful or not.

Naturally, the private pension institutions quickly recognised the opportunities inherent in providing information, and the leaflets they published tried to assist an understanding of the new system. But the quality of these leaflets varied widely, since a fund wishing to interest people in becoming its members with – from a marketing point of view – well targeted, professionally produced materials, needed quite a large amount of money. This was the initial point at which the unequal opportunities open to different funds became increasingly clear. Funds with a bank or insurance company background had an almost overwhelming advantage in preparing publicity material and in getting this to potential fund members. Eventually these funds filled the information gap that would have been a serious problem for individuals who were forced to make decisions about their pensions.

It must be asked whether, if information with the necessary detail had been provided by the government what chances of success would the smaller funds, principally the ones with an employer background, have had? The current level of concentration of pension assets could be justified economically if pension funds organised on market principles and those organised on non-market principles had started up on an equal footing. It cannot be known whether an institutional structure providing more efficient member protection could have arisen if all the concerned parties had initially received the necessary information to enable them to understand the opportunities of the pension fund system.

What is a Hungarian "pension fund"?

In Hungary it has been possible to found and operate pension funds since 1993. Initially, the so-called voluntary mutual pension insurance funds could be formed. Members could enter these pension funds – as their name shows – voluntarily, and they could also determine the amount of contributions – called membership fees – themselves. The legal background of their operation was regulated for the first time by Act No. XCVI. of 1993.[5]

The 1998 pension reform established a new institution within the mandatory pension system, which is called a mandatory private pension fund.[6] The operation of mandatory private pension funds is the same as the operation of voluntary funds in many respects, but there are also significant differences. One of the main differences is that in the case of mandatory private pension funds, it is not the member (or the fund) who decides the amount of the contribution – that is, the membership fee – they wish to pay, but it is prescribed for them by the law. The other important difference is that mandatory private pension funds do not add to or replace, but work together with the pension provided by the social security system. Thus, those Hungarian citizens entitled to asocial security pension, and who have entered into a mandatory private pension fund, will receive a lower social security pension – since they have paid lower contributions – than those who retire as non-mandatory private pension fund members.[7]

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5. Since 1993, the law and the related regulations have been modified several times, only partly due to the need to fine-tune the legislation. Yet the most important aspect of pension legislation should be its long-term stability.

6. Act No. LXXXII of 1997 on Private Pension and Private Pension Funds was accepted by parliament on 15 July 1997.

7. The amount of social security pension in the new pension system is calculated by using the amount of the average income as the basis for contributions multiplied by the actual length of time spent in

However, ordinary individuals are totally confused by the pension concept. Phrases such as "voluntary mutual insurance fund" and "mandatory private pension fund" have caused quite a lot of confusion in themselves.[8] At the time of the introduction of the 1997 Act, there were few people who could differentiate between pension insurance[9] traded on the life insurance market and the services of pension funds. This situation has not changed much in the last seven years, especially as most insurance companies sell both pension insurance products and pension fund services at the same time. This is quite reasonable, since the purpose of pension funds is practically the same as that of pension insurance, and they are really only different organisations with the same objective, namely the implementation of individual income provision for old age.

A pension fund, however, (and here this means a private pension fund established as such by the law) is only one of the possible institutions for implementing individual provision of old-age security. But it cannot be said to be the only institution catering for individual provision for an old-age income, as has happened in Hungary. Moreover, it is not clear that this kind of individual provision should be implemented by institutions such as these regulated private pension funds. What would have happened if this new institution had not existed? It is possible that the already existing money market institutions would have undertaken the management of pension savings – with incentives from tax relief – without being forced to establish pension funds that comply with the legal requirements laid down by the government. Looking at the situation in this way, the "concentration" experienced in the Hungarian pension fund market can be understood as the financial institutions, already in the market, recapturing the pension savings market which was forcibly taken away from them by the imposition of legal regulation.

The pension fund is actually a pension fund managing institution, the owners of which are the members themselves.[10] But this is not clear in the current situation. The background institutions of the leading pension funds, the banks and insurance companies, behave exactly like pension fund managers. That is, they undertake the responsibility of managing savings provided for pension purposes as part of their basic commercial activities, which they pursue in order to make a profit for the financial institution's owners. Of course, this is not necessarily contrary to the interests of the members. The business reputation of the background institution can ensure that a basic security exists for members' investments. In addition, members may obtain a direct advantage from the fact that, in conditions of significant market competition, maximising yields can be the strongest way of retaining members, and thus the background institution may direct proceeds arising from other sources, towards the pension fund.[11] But if this competition disappears, for example as the result of a fund cartel, the

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service multiplied by a pension multiplier. The pension multiplier is 1.22 in case of private pension fund members, while it is 1.65 in all other cases. Consequently, private pension fund members receive a pension from social security that is 26% lower than is the case for non-members of such private funds.

8. Even the English translation of the Hungarian legislation is somehow confusing. The Hungarian private pension institutions are called "pension funds", but these are not purely a "pool of assets" as is commonly meant by the expression "pension funds".

9. After the appearance of pension funds, the character of pension insurance products offered by insurance companies became in many respects more similar in character to the services offered by pension funds.

10. Probably the "mutual" attribute appearing in the title of mutual funds refers to the fact that the operating principle of Hungarian pension funds most resembles the Anglo-Saxon "mutual funds", that is, pension funds operated on the principles of mutuality.

11. This can happen in a way that ensures support for the operation of the pension fund from its own profits, but it is also possible that at the time of allocation, the fund assigns investments with more

business interests of the background institutions may then be their major concern that could adversely affect members' interests.

This is the reason why it should be considered whether large financial institutions should be allowed to manage pension funds in exactly the same way as they do their subsidiaries. This is because in doing so, they tend to ignore the fact that the Hungarian legislation on pension funds defines different ownership structures in Hungary for such funds compared to their other subsidiaries.[12]

Raison d'être of small pension funds

At the time of the creation of pension funds, a relatively large number of mainly small pension funds were founded, the raison d'être of which caused much disagreement among professionals. One view is that it was wrong from the start to allow the establishment of small pension funds.[13] Some argued from the beginning that proper business operations are impossible with memberships smaller than a certain size, and they pointed to the dramatic decrease in the number of pension funds established during earlier attempts to found such institutions. The most serious argument against small pension funds was the uncertainty of their long-term operation. These funds – practically without exception – are heavily dependent on particular individuals and can get into deep management crises after a key person's position is terminated. Moreover, the aspects of the activities of pension funds which resemble those of financial institutions, the professional skills needed and the strict customer protection requirements, all indicated that the institutions established for the management of pension funds cannot be operated in a quasi-amateur way. And small organisations cannot really ensure the necessary level of professional expertise.

From this perspective, it is understandable that certain pressures have been exerted on small funds almost from the beginning, even by the state supervisory authorities. Employers in selecting funds have excluded small funds operating without background financial organisations, and they have chosen from the funds with a bank or insurance company background as they considered this more appropriate.

Nevertheless, some organisations did take a different approach to creating pension funds. Several were founded that did not target market-based growth. These were and remain funds established with a few tens of members that considered the foundation of an independent pension fund the best tool to achieve a kind of specific community interest. In most cases, these funds were established upon the initiative and with the support of an employer, but there are examples where geographical communities based on municipalities – by taking the text of the act seriously – established small pension funds. These fulfilled the technicalities of operating as such by contracting with professional organisations to undertake these functions. These funds were intent on independence and their founders were primarily motivated by their view that the fund was not a "factory" that had to operate economically, but an interest enforcing organisation that ensured its ability to operate by the manner in which it organised its operations. But in order to achieve this, it was essential to have an appropriate

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favourable yields to the pension fund reserves. In an extreme case – especially in the initial periods of gaining market share – the published yields of certain pension funds with a financial institution background were significantly higher than the market average, while the efficiency of other funds managed by the same background institution lagged behind the market level.

12. Of course, this behaviour by financial institutions does not call into question the ownership of individual pension capital, but only members' autonomy, which is defined by the Act.

13. The Act allows the foundation of a voluntary pension fund with only 15 people, while in the case of private pension funds, the minimum membership is 2 000.

economic environment where business enterprises, which could offer expert services to these small funds at competitive prices, existed. However, the change of the market climate did not favour these small funds which eventually – as it has been indicated by the figures mentioned above – came to represent a smaller and smaller share of the pension fund market.

It is not impossible that small and medium sized funds will effectively disappear from the Hungarian market in the future. According to some more realistic expert estimates it is expected that, apart from the four to five dominant pension funds covering 85-90% of the market, a maximum of 10-12 mandatory private pension funds and about 70-80 voluntary funds will remain, while the others will sooner or later cease operating.

But before saying a requiem for these small funds, their undoubted merits must be appraised. The heroism accorded to pioneers cannot be taken away from them, as they contributed significantly to the success of the pension reform. Due to the transparency which small operations have, they assisted in exposing the many weaknesses in the pension fund laws and they were most effective in finding efficient solutions to these. Moreover, there were people in all of the small funds who learned the business of how to operate funds and, as a result, a group of professionals has been developed with strong skills in pension fund management.

It was fortunate that it was possible to establish small funds in the early phase of the operation of private pension funds. The small voluntary funds were able to be experimental workshops where many different aspects of the private pension system could be worked out. The author is convinced that without them, the introduction and unprecedentedly fast growth of mandatory private pension funds would have been impossible.

Operation of pension funds

In order to undertake the activities necessary for the operation of pension funds such as accounting, financial, and actuarial professional functions, administration services (accounting and customer account registration), and investment activity and asset management, several organisational solutions evolved. The simplest organisational structure is represented by those funds that provide nearly all the required operational activities themselves. This means that the pension fund concludes contracts only for banking and asset management services, and, of course, it also has to select an auditor. But it undertakes both its administration and investment activities itself. Only a few funds operate such a simple structure. The main reason for this is that a fund's managers are elected from the members, and have to make decisions on the merits of very technical issues for which they usually need expert professional advice.

The simple structure referred to above also has another significant problem, namely that of ensuring that the costs related to asset management are properly accounted for. If the fund assigns an external organisation to pursue its investment activities, then all the costs charged by that organisation – and also the cost of investment expertise relating to asset management – can be clearly and separately accounted for. In contrast, in the case of asset management undertaken by a fund itself, the amount paid to the investment experts of the fund is an operational cost, which can only be accounted for as a charge on operational reserves.[14] But this can only be ensured if the fund works

14. The fund creates three types of reserves from the members' contributions in a prefixed ratio: the majority of contributions are included in the so-called insurance reserve that is credited on accounts held separately by members. The fund is also obliged to accumulate so-called liquidity backups, which serve as the backup of the fund's operational and investment risks. And finally, operational

with an operational cost ratio that is higher than the market average.[15] However, this can cause a perceivable market disadvantage, since practice shows that members are much more sensitive to this issue than to differences in investment yields that determine a fund's profitability more significantly.

Presumably the organisation-dependent character[16] of cost accounting also contributes to the fact that pension funds nevertheless do not usually engage in asset management, but conclude an asset management contract with a specialist institution. So, although it has an expert service provider for asset management, it is forced to employ an investment adviser with a high level of professional expertise. It should be pointed out that the deposit manager is institutionally obliged to check the asset manager from a professional point of view, and the auditor is also bound to approve the asset management provided. This regulatory requirement is unnecessary over-insurance, which − again − disadvantages self-organised funds that were established to represent in a genuine manner the interests of members, but that do not have expert managers.

The most widespread operating structure is when, in addition to the asset management activity, the fund also engages an external service provider organisation to undertake the fund's administration and those of its other activities requiring professional and technical expertise. In this situation, the fund's elected managers do not necessarily have to be technical experts and their main task can be the efficient representation of members' interests. For small funds this is the only workable organisational solution.

In practice, this organisational form has also been adopted in cases where the financial institution operating as the background institution of the fund wants to ensure that it retains the most profitable fund activity, namely asset management. The easiest way to guarantee this is if the members of the fund's executive bodies – preferably all of them or at least the majority – are effectively representatives of the interests of the background institution. For example, they are employees or executive officers of the background institution, while the "external" service provider firms are enterprises related to (*e.g.* being in the ownership of) the background institution. In many cases, the board of directors of a fund – consisting of the executive officers of the background institution – is in the position of deciding whether a fund's asset management should be contracted out to or kept by an asset management firm which is the background institution's own property, while accounting is done by a fund service provider that is also related to the business interest of the background institution. The law has only one requirement to resolve these conflicts of interest, namely that the custodian manager and the asset manager cannot be in the same ownership.

Of course, there are those among the market participants who know how to get around this rule. This can be done if the owner of one of the companies mentioned above is the parent company and is registered abroad, while the owner of the other is the background institution itself in Hungary. Then there is, legally, no conflict of interest. Alternatively, a board of directors consisting of the employees

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reserves have to be created from members' contributions to cover the fund's operating costs. On the pension fund market this ratio is usually: 95%-1%-4%.

15. Funds with a financial institution background have decreased the rate of operational costs deducted from contributions to a level that is significantly lower than that necessary. In their case it is not necessary to have a self-sustaining level of revenues for the operating costs, if they consider the profit of the asset management activity a part of the performance of the business's bottom line.

16. Among the funds data made public, it is not yet seen how the total operational costs (the amount actually utilised for operational and asset management purposes) relate to contributions or to the fund's assets, although where there is free market competition, this information could be the real measure of value.

of the firm which is the deposit manager and a background institution engaged in banking services can decide between them that asset management is to be done by the fund itself, but the expert to be employed as the investment director is actually one of the employees of the background institution's investment arm. In such a case, the real task of such an investment director is to channel the largest possible part of the investments made by the pension fund in such a way as to benefit the interests of the background institution. And though this sounds unethical, it is not actually that far from what really occurs and, in practice, the decisions made do not necessarily appear always to be contrary to the interests of the fund concerned.

The main question in all these situations is: how are the interests of members effectively represented where these are opposed to the interests of the background institution involved with a fund?

Role of the employer

In the former state pension system, the employer's role was limited to paying the contribution prescribed by law to social security in proportion to the wages paid by him. But during the pension reform, the employer's obligations and opportunities have changed radically in relation to the provision of an employee's pension.

While the obligation to make payments to social security remains, a separate law requires employers to comply with any employee's decision to make contributions to mandatory private pension funds from the pension contribution deducted from the employee's wages, by paying these and declaring that they have done so. Payments are made towards as many different mandatory private pension funds – according to strictly regulated formal requirements – as is decided by the employees of a firm. The administrative load on employers has increased significantly as a result. So employers' efforts to try to "encourage" their employees to be members of the fund (in better cases, funds) preferred by them, is understandable. Experience shows that this encouragement can take drastic forms in situations where an employer practically forces all of their employees to enter the same fund. Employers respect, more or less, the right of free fund selection in the case of joining voluntary funds, but in the case of mandatory private pension funds – due to the strict declaration system that requires considerable work – it is not surprising that employers try to ensure that all their employees join the same fund. Of course, this can work in the employee's favour, if the employer also undertakes continuous monitoring of the fund's activities. There are examples of an employer having the fund it selected (into which it enters all of its employees) analysed by an external expert. If that expert does not find that fund's performance satisfactory, then the employer undertakes to enter all of its employees – again, all into the same fund – into a fund which the expert considers more efficient. Only in cases where the employees are clearly disadvantaged by their employer's choice of fund, can any coercion to join the fund be challenged.

The employer's responsibility is further increased by the fact that the amount of pension that an employee can expect from the mandatory system, will be influenced more directly in the future by the size of the wages which the employer declares are being paid, and by whether the employer has regularly paid to the fund the contribution deducted from an employee's wages. On the one hand, this means that it is in the interest of workers to seek to minimise the "black" or "grey" wage, which is still significant in the labour market, though it is possible that it will take time for employees to realise this. On the other hand, it is not obvious that employees will be able to compel their employers to act in their (the employees') interests. Nevertheless, the fact that employees are notified in their annual individual account notices as to whether their employer has paid the contribution deducted from their wage to the pension fund, has had a perceptible influence in improving contribution payment discipline. Though the collation of declarations and payments puts a very heavy administrative burden

on mandatory private pension funds, it has produced noticeable results in the area of contribution payments. It must be noted, however, that the obligation on funds to report to the Tax Financial Supervising Authority any failure to collect contribution debts from employers has aroused their animosity. The enforcement of this regulation has faced serious opposition because funds are primarily interested in keeping members and they know that if they report an employer to the TFSA for failing to pay contributions, that employer will probably force its employees to leave the fund.

The most important change in the employer's role in relation to pensions is probably that the employer – as part of fringe benefits made to employees – can voluntarily contribute to the savings that an employee makes towards a supplementary pension. The employer can, as one option, undertake to pay a contribution supplement in addition to the mandatory membership contribution for employees who are mandatory private pension fund members. Experience shows that employers don't really like to do this, primarily because those who are not – and cannot be – members of the mandatory private pension fund cannot receive this benefit. And employers do not usually like those forms of benefit from which certain groups of their employees are excluded. At the same time, due to the contribution ceiling, this contribution can only be a limited amount,[17] which does not provide a really attractive form of benefit for employee groups receiving a higher income. In contrast, in the lower wage categories, it can mean too large a benefit is provided which may not be the employer's intention.[18] Small enterprises pay the employer's supplementary contribution supplement to the mandatory private pension funds, as the important objective for them is to minimise additional charges.[19]

Those employers, for whom the payment of the employer's supplementary pension contribution represents a part of the benefits they give their employees would prefer to pay this to a voluntary fund. In the initial period of the voluntary fund system, it could be observed that those employers who paid the supplementary contributions willingly undertook to establish their own, closed employer's voluntary pension fund. The employer's funds operating under the name of the company concerned significantly contributed to increasing the value of the corporate image of that company. Apart from its financial contribution, an employer usually undertook its own professional monitoring of the firms providing services for the fund and also a continuous analysis of the market situation. In addition, by exploiting its professional prestige, it often achieved very favourable service fees from the service providers. As a result, employees felt their savings were safe. It is noticeable that members made larger payments themselves to these closed funds than the average of payments for supplementary pensions which, again, shows the trust put in such funds.

But today, most of these employer's funds are terminated or merged into other funds. A further contributing factor is that certain employers, pleased with the success of voluntary funds started to organise mandatory private pension funds too. However, they were not prepared for the complexities involved and eventually had to give up providing their own pension funds. In many cases, the difficulties mentioned earlier, which are generally typical of the operation of small funds, had contributed to the termination of the fund. The cost of operating a closed fund exceeded its human

17. In 2000, the income ceiling serving as the basis for contributions is HUF 2020 000. So the maximum amount of the contribution supplement that can be paid to private pension funds is 4% of that figure that is, a maximum of HUF 80 000 annually.

18. The employer is required to pay the same amount of contribution supplement for all [their] employees.

19. The contribution supplement paid to private pension funds means a net cost for the employer, which is not subject to further charges. That is, in the case of a small enterprise, it is very favourable for the owners declared as employees, if they pay the pension fund contributions credited on their own individual accounts for the charge of their enterprise as a cost.

resource advantages. The behaviour of the large pension funds, using not only marketing tools but also sometimes more importunate methods of member recruitment also contributed to this development though of itself such conduct it would not have been enough to get so many employers to give up their pension operations.

The main problem for the Hungarian pension fund market is not the current level of concentration of funds, but the small market share represented by employer's funds. This is the most negative characteristic of the development of the Hungarian pension fund market, as the vision of what the appropriate role for employers was to be, was much greater when the reforms were being developed than it has turned out to be in practice.

Instead of a summary

The Hungarian pension funds have been in existence for a very short time historically, as the time which has passed since their formation is a short one in which to collect savings, and even more so as far as providing pension services goes. However, the basic structure of the market has been put in place, and though there will surely be attempts to alter this, no fundamental change can be expected in its structure.

This brief study does not intend to undertake a detailed description of the state of the pension fund market, nor of the operations of the pension funds. Its aim is to identify those significant phenomena that have led to the emergence of the main features of the Hungarian pension fund market in 2000.

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Chapter 17

THE ROLE OF PRIVATE PENSIONS IN THE CZECH PENSION REFORM

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Developments before 1990

Social insurance on the territory of the Czech Republic has a tradition that is more than a hundred years old. To a certain extent, this history also influences the decisions being made on the future of the pension system.

The system of obligatory social insurance in the Austrian part of Austria-Hungary, which also included the Czech Lands, was introduced in 1888-1889 (the "Taaffe Reform"), along the model of Bismarck's reform in Germany. It had become clear, at that time, that the principle of voluntary insurance had not been very effective, since some employees did not take sufficient responsibility to provide for their own future. This experience, as well as the development of industry, and the changes in society as a whole, was the reason for the transition from self-help associations, trusts and workers' insurance funds, based on the principle of voluntary mutuality, to the system of obligatory insurance of employees. The Czechoslovak Republic adopted the original Austria-Hungarian social security regulations, which it then started to develop. The laws of the First Republic continued to have effect after World War II. The situation was greatly complicated by the fact that social insurance funds had either been confiscated, or devalued, by the wartime economy. An important milestone in the development of social legislation in the former Czechoslovakia, was the adoption of the Social Insurance Act in 1948. This law was modern and progressive in its time; it was based on the model found in the Beveridge Report. The law provided for the implementation of a new, unified, national insurance system, which placed on a more equal footing, the rights of blue-collar workers, and of other employees, and for the first time, extended old-age pensions to private farmers. After 1948, the original intentions of the Social Insurance Act became increasingly distorted; the new regulations, made subsequently, bore marks of the strong influence of the Soviet model. In essence, this meant that responsibility for the care of citizens was taken on by the state, as an expression of the ideology of the redistributive concept of socialism, that is, the transfer from a system of social insurance, to a system of social security. In spite of these tendencies, the Czech pension system did preserve certain elements of "insurance", because the right to a pension continued to depend on the length of the period of employment, and on the amount of income, although the relationship between these factors, and the amount of pension, was restricted, in various ways. This, then, was the background, that later led to the reform introduced in 1989.

Pension security in the Czech Republic before 1989 was, in principle, very generous, especially towards certain groups of individuals. This generosity was particularly reflected in the conditions for entitlement to benefits, rather than in the level of the benefits. In actual fact, all citizens were covered by pension security. Various forms of preferential treatment, using both benefit rates, and conditions of entitlement, gave certain groups better treatment than that available to those dealt with in the normal way, under the pension system. On the other hand, there were certain groups of people against whom the system discriminated – for example, self-employed persons. The usefulness of blanket provision of certain pension benefits started being questioned, when these benefits no longer met their purpose. The system of pension security provision was financed from the state budget, and contributions into the system were an undefined component of tax.

A critical analysis, of the relevant legislation that was in operation, was performed in 1990. It revealed serious defects in the system, that would have a very strong negative impact on the system of pension insurance, during the transition to a market economy. The main defects indicated were the following:

- The static nature of the system based on a system of restrictive provisions. No rules existed, to enable change in these restrictions to occur. The level of pensions could not, therefore, react flexibly to developments in wages and living costs.

- The amount of the pension did not adequately reflect the level of earnings obtained during the whole of a person's active working life. The pension was calculated only on the basis of the five best years (income-wise), out of the last ten working years before retirement.

- The lack of preparation for the future age structure of the population. In the future, the ratio of economically active persons to pensioners will decrease. This means that an increasingly smaller number of economically active persons will be creating the resources needed to pay for a growing number of pensions.

- Few options for individual decisions about the age of retirement.

- Insufficient protection for the system, against abuse of certain lax conditions.

- The impossibility of "transferring" accrued entitlements to other countries, at a time when freer movement between countries is possible (both during working life, and after pension age).

- The limited opportunities for obtaining individual, voluntary, forms of pension insurance.

Thus, in 1989, there was the legacy of an ineffective, complex, pension system, unable to respond to the expected demographic and planned economic developments.

The aim of the pension reform was to resolve these shortcomings. That has only been possible, however, by the implementation of essential changes, resulting on the one hand, in an improvement of the existing situation, and on the other hand, to certain unavoidable restrictions being put in place, to maintain feasible pension costs at a reasonable level.

Developments in the period 1990-2002

The pension system in the Czech Republic is not at the beginning of a reform "leap". On the contrary, it is in the midst of a reform process, which was started in 1990, as a consequence of the political, economic and social changes, that took place after 1989.

In 1990-1992, the discrimination against self-employed persons was removed, and preferential treatment abolished. The measures resulted in all economically active people acquiring entitlement to pensions, under uniform conditions, thus giving rise to extremely favourable conditions for undertaking future reform.

In 1993, pension insurance contributions were introduced, as a special payment outside of the taxation system. Draft legislation on occupational supplementary pensions was submitted to the government, for discussion. The government, however, rejected the concept, and an individual supplementary scheme, in an open pension fund, was created. In 1994, Supplementary Pension Insurance was brought into being, under the State Contribution Act.

In 1995, following major expert and political debates, a new Pension Insurance Act was enacted. It introduced the dynamism that the new economic conditions demanded. The process of increasing the retirement age was started, a flexible retirement age was introduced, the period for which earnings could be used, as the basis upon which a pension was calculated, was prolonged gradually, the definition of disability was specified more accurately, widower's pensions were introduced (contributing to the enforcement of the principle of equal treatment of men and women), and the compliance of the system with European Union rules, was ensured.

Since 1996, a special pension insurance account has been a part of the government's financial assets, allowing a clear definition, albeit within the context of the state budget, of the finances of the pension insurance system. In 1997, as a part of the austerity measures, indexation of pensions was tightened, and some non-contributory periods of insurance (*i.e.* periods when contributions are not paid, but which are taken into account in the calculation of the benefit amount), were made stricter. However, the scope of non-contributory periods still remains very generous, compared to other countries. In 1999, an amendment to the Supplementary Pension Insurance, with the State Contribution Act, was enacted, enhancing, somewhat, the security of deposits made by scheme members, but mainly expanding the possibilities for increasing the state contribution, providing tax advantages for employers paying contributions on behalf of their employees, and providing a tax allowance for a part of the contribution paid by scheme members.

In 2000, a high-level Interim Committee for Pension Reform was established. in the Chamber of Deputies. In November 2000, the government submitted to the parliament the Social Insurance Agency Bill. The aim of this legislation was to separate the financing of social insurance, from the state budget, and thus to enhance the transparency of the management of social insurance resources, to reduce the dependence of this management on political decisions, and to allow better and more flexible contact with clients. However, its main purpose was to create, by transforming the current scheme into a modern entity, the prerequisites for further reform steps.

In 2001, an amendment to the Pension Insurance Act provided for an actuarially fair reduction of old-age pensions, where a member of the scheme retired early, and for an increase, where retirement was deferred. In April, the government approved, and sent to the parliament, for further discussion, its report on the "Further Continuation of the Pension Reform". In October, the parliament rejected the governmental draft amendment of the Supplementary Pension Insurance with State Contribution Law, and also, after discussions which lasted one year, the draft on the Social Insurance Agency. The

financing of social insurance has, thus, remained part of the state budget. In October, the government sent to the parliament the new law on Occupational Supplementary Pension Insurance, but in December, it was also rejected**.** The Parliamentary Committee on Pension Reform finished its deliberations in December, without reaching a consensus on the next steps to be taken. In the period 1990-2001, pensions were adjusted, sixteen times. After the experience of (not very successful) government legislative initiatives during the last two years, it is much more apparent, that broad political and expert consensus is the most important condition, for further development of the scheme.

In order to promote broader consensus among different countries, the Czech government, in 2002, together with the government of the Netherlands, prepared the Joint Memorandum on Pension Reform, for the Summit of the EC in Barcelona. Its aim was to support the principles of the welfare state, and the post-Lisbon discussions, and to indicate that the Czech government was ready to be included in the discussions, between EU Member States, on the future development of the Member's pension schemes.

The current situation in pension reform development

There are a number of problems that need to be solved, both in the mandatory, basic pay-as-you-go (PAYG) pension insurance system, as well as in the voluntary, private, fully funded supplementary scheme:

- The decrease in the real value of pensions.
- The high degree of levelling out of pensions, resulting, in particular, from the unsuitable method of calculating pensions (the degree of levelling out still remains higher than prior to 1990).
- The increase in the number of early retirements, resulting in stagnation of the real retirement age (men 60 years, women 56 years).
- The increased proportion of pensioners, compared to the total number of those paying contributions, resulting, in particular, from demographic developments, the increased number of early retirements, and the reduced the rate of economic activity.
- The low contributions paid by the self-employed: this has led to the cost of paying their benefits being increasingly transferred to employees, employers, and the state budget.
- The number of people not contributing to the system (approximately 30%), which has become the main reason for the imbalance between income from insurance premiums and expenditure on benefits (the so called non-contributory periods).
- Insufficient security for assets invested in private supplementary schemes.
- Insufficient transparency of management, and the high costs of administration.
- The short-term nature of the supplementary scheme, which serves rather as an advantageous savings scheme, and not as the means of providing funds for old age. The support provided by the state (contributions and tax deductions) does not therefore fully fulfil its aim.

In April 2001, the government approved the report prepared by the Ministry of Labour and Social Affairs, The Concept of Continuation of Pension Reform. The report addressed the present, and future, problems of the pension system, and contained proposals for possible developments, and necessary changes.

The report was sent to the parliament, for further discussions. After several months of discussions, it has become clear that the government concept is the only detailed concept in the country. Nevertheless, there are also other quite different ideas, presented by certain political parties. For example, the ODS party prefers a low flat-rate pension, with voluntary savings on top of it, whereas the Union of Freedom prefers mandatory private savings, as a second pillar. Thus, it is clear that the concept proposed by the majority in the parliament for further development of the Czech pension scheme, may only be adopted after the election, which takes place in June 2002.

The following principles of the future pension system are part of the government report, from April 2001. In spite of different opinions on future developments, it seems that they may be taken as the guidelines for any future reform:

- *Maximum possible participation (coverage) in, and uniformity of, the system.* The basic mandatory system must not motivate the economically active population to evade the legal labour market, so as to avoid payments of premiums. The system must not contain preferential treatment, for any group of insured members. Additional voluntary pension systems must provide maximum incentives for participation (security for investments made, tax advantages, and a variety of products offered).

- *Financial feasibility of the system*. Taking into account short-term and long-term projections, the basic mandatory system must be continuously adapted, to ensure its long-term durability, in the light of the ageing of the population, and to ensure its ability to react to demographic developments, migration and inflation. The essential parameters of the system must be adjusted, so that benefits will be at an appropriate level but, at the same time, the costs of the system must not excessively burden the economically active part of the population.

- *Maintenance of solidarity between generations, in the process of payment* for the basic PAYG system. Additional forms of capital saving, in typical financial products, should be supported, in their voluntary forms only. Among the other factors, to be taken into account, it should be remembered, that such systems require considerable costs for the transition period, and involve a high level of social risks, related to the introduction of mandatory systems of saving.

- *A stronger link between the amounts of premiums paid, and the amounts of benefits received* would limit excessive levelling out within the basic system; additional systems should be developed on the basis of the principle of full equivalence.

- *A guaranteed minimum income,* for a pensioner, should ensure that, after many years of participation in the system, a pensioner should not be dependent on income *(i.e*. means) tested social benefits.

- *Increased personal responsibility* by citizens, and also by the state (or system administrators). This responsibility must cover preparation for old age, the security of the system, and the availability of information to the population.

- *Improved trust of the population in the insurance system,* by means of the increased transparency of the system, and its transformation, from a state body, to a public Social Insurance Agency. Such an agency would be able to fulfil the tasks related to future changes, in the area of incomes and benefits, and will become a client-orientated institution, providing financial services, and information, with the support of the latest technology, so that members can be aware of how their contributions are used.

- *An improved rate of employment,* by eliminating any motivation for early retirement, by eliminating barriers for entering the labour market, and especially by supporting the longest possible period of economic activity of each person.

- *Fulfilment of the requirements resulting from relations with the EU* – not only by means of harmonisation of legal regulations, but also through the quality of their implementation, and enforcement.

The concept of the government

The pension system will be based, in the future, on a mandatory PAYG system, guaranteed by the state, and on voluntary private, supplementary, fully funded schemes. The proportion of the income of those on old-age pensions, to which such voluntary private schemes will contribute, will be gradually increased, up to approximately one-fourth of the total. The system will ensure appropriate compensation for low-income, medium-income and upper medium-income groups.

An average old-age pension, on the level of 55-60% of gross salary (about 45% of net salary), will be provided, from the basic mandatory pension insurance system, for at least another 10 years. Currently, the amount of pension received decreases, as a proportion of total salary, as an individual's salary increases. The proportion of total salary, which can be received as pension benefit will, in future, be increased, thus strengthening the principle of equivalence.

After 2010, following the development of other additional systems, the above-mentioned incomes of pensioners, from the basic system, will be supplemented, with additional incomes from voluntary private, supplementary, pension schemes, with the state contribution to these amounting to another 7-10% of net pre-pension income. There will be additional incomes, from supplementary occupational pension schemes, amounting to another 7-10% of net pre-pension income.

The system of basic, mandatory, pension insurance will be guaranteed by legal, economic and administrative methods.

Fundamental principal corrections will be made in the PAYG system, which will ensure the stability of the system. As an alternative, it is proposed to arrange a gradual transition, from the current defined benefit (DB) PAYG system, to the notional defined contribution (NDC) PAYG system. The introduction of this latter system would make possible the carrying out of a fundamental reform of the pension system, in a gradual way, and without large additional costs. Moreover, a smooth transition to an NDC system could be arranged, without creating significant differences between the pensions granted during different periods (prior to starting, during, and after the end of the transition). The transition to the NDC system will make considerable demands on the administration of the insurance system, since the new system is typified by a high demand for information. This is related, among other things, to the fact that individual accounts for insured persons will have to be established, and managed, and that, for a certain period, two different pension systems will have to exist alongside each other.

The current state administrator of the insurance system (the Czech Social Security Administration), will be transformed into the public Social Insurance Agency, the finances of which will be separated from the state budget. This agency will be responsible for improving the system's administration, and its transition to an up-to-date client-orientated financial institution. This is the only way in which to create the pre-conditions for further reform measures. Experience from abroad has shown that underestimating the need for a thorough preparation of the administration of the system, may jeopardise any reform, however well-intentioned. Therefore, the establishment of the Social Insurance Agency, is considered to be a high priority.

Additional pension schemes will be further developed, by means of the establishment of the second pillar of the system (collective employee's insurance), in compliance with best practice in developed countries, and by strengthening the security, and transparency, of the third pillar (individual systems of private, supplementary, pension schemes, and life insurance), and increasing its long-term nature.

Overview of the supplementary pension scheme with state contribution

The supplementary pension scheme was designed, in order to allow people in the pre-retirement age group, to enter into the system. Between September 1994, when the first private pension funds received their licence, and the end of 1996, more than 1.5 million people entered the supplementary, private, pension scheme (in 2002, the number of participants exceeds 2.5 million). On the other hand, the supplementary, private, pension scheme became characterised, as a short-term saving scheme for purposes, other than those of providing a supplementary income in old age, which was undesirable. This was partially due to the low retirement age, for receipt of the old age pension (50 years), and to a short vesting period for a pension (maximum of five years).

After its successful start, in 1994, the system began to show signs of stagnation. In spite of the fact that wages were growing, participants were not increasing their contributions, and the average contribution level remained at approximately CZK 300, and. the participant's maximum contribution limit of CZK 500 has not been increased. The state contribution has not been adjusted, so that it can increase when the participant's contribution increases. The state supervision of this system is restricted in its extent.

After several years of the system's operation, the long-term aspects of the supplementary, private, pension scheme were strengthened, and a greater emphasis was placed on its purpose as a support in old age. The amendment of the Law on Supplementary Private Pensions introduced stricter conditions (for instance a retirement age of 60 years). At the same time, it introduced further incentives for participation in the system – a higher state contribution, tax allowances for participants, and also for employers, if they make contributions to the funds of their employees' pension schemes.

The supplementary private pension scheme, with state contribution, is based upon long-term payments of smaller contributions to a pension fund. The pension fund increases this capital, by making appropriate investments. Participants themselves decide on the amount of their contributions. The state provides, to each participant, a state contribution (CZK 50-150, monthly).

The fundamental benefit of the supplementary, private, pension system, is the old-age pension. Apart from this, the disability pension, and the short-term survivor's pension, can be provided. Only DC types of plans are allowed.

The amendment of the Law on Supplementary Private Pensions, in 1999, terminated the provision of temporary old-age, disability, and retirement pensions. Once a participant in the scheme

has met the conditions for entitlement to a pension, that participant can decide to have, instead of the pension, all the money to which they are entitled, in the form of a one-off settlement. If a participant wishes to leave the supplementary private pension scheme, before becoming entitled to a pension, the participant receives back the contributions paid, in the form of a severance payment. This includes the investment returns, but not the state contribution, or the returns from the state contribution. As the supplementary pension scheme will not have met its purpose, the state contribution does not belong to the participant.

Enrolment in the supplementary, private, pension scheme, with a state contribution, is voluntary, for the participants. The enrolment conditions are: a minimum age of 18 years, and permanent residence in the Czech Republic. There are no links to working in a particular occupation, or at all, as this is not a system based on employment, but on the concept of participating in civil society. Remaining in the scheme is a voluntary decision of the participant, who can leave it at anytime. If the participant does leave the scheme, the financial assets deposited will be paid back to the participant, in the form of a severance payment, as described above.

The amount of the life pension is determined, on the retirement of the participant, by dividing the money held in the participant's individual account, by the period of the participant's average life expectancy, as set out in the mortality tables of the Czech Statistical Office. The amount of a pension is not pre-determined, in the defined contribution scheme. It depends, not only on the amount of the participant's contributions, and the state contribution, but also on the level of returns obtained by the pension fund's investments. It also depends on the retirement age, and on the participant's gender (mortality tables vary for men and women).

Where a participant is dissatisfied with their pension fund, they can, at any time, give two months' notice to leave, and enter another pension fund, and also obtain the transfer of their financial assets. It should be noted that changing pension funds is not economically beneficial for participants, because of the administrative costs involved. However, if a participant is not satisfied with their current pension fund, it is preferable that such a participant changes their pension fund, but remains in the supplementary private pension system, rather than leaving the system altogether.

A private legal entity, private joint stock companies, that is, pension funds operate the supplementary private pension schemes, with a state contribution. Pension funds have stricter rules for the establishment, operation and termination of their activity, than ordinary joint stock companies. The principal ones are that:

- Approval of a state authority is necessary, for the establishment, and termination, of their activities, and for a consolidation, or merger.

- The registered capital of a pension fund must amount to at least CZK 50 million (CZK 1 million is sufficient for an ordinary joint stock company). When the fund starts up, this must be constituted, only, by a monetary deposit, and paid up, prior to submitting an application for the pension fund's establishment.

- The law defines rules of safe, and provident investments, for the purposes of the private pension funds, and preference is given to a safe investment, with lower returns, rather than a risky investment, with higher returns.

- Certain mechanisms exist, to control the funds (rules about deposits, state supervision of the pension funds).

- The method of profit distribution is defined by the law – a maximum of 10% of the profit belongs to the shareholders, a minimum of 5% of the profit belongs to the statutory fund, and the remaining amount is distributed, for the benefit of the participants.

- Members of the management board, members of the supervisory board, and the secretary of the pension fund, are subject to approval by the state authorities, and must comply with requirements for professional competence, have no criminal record and must be in compliance with the rules against potential conflicts of interest, in terms of their other work activities.

- The state supports the supplementary private pension system, in four ways.

State supervision of the pension funds

The activities of pension funds, and of their depositories, (the banks that maintain pension funds accounts) are subject to state supervision, by the Ministry of Finance and by the Securities Commission. Such state supervision comprises both controls and sanctions (for instance, the imposition of penalties, the suspension of the entitlement of the management board to handle the pension fund's assets, and the ability to appoint custodian, and to withdraw of a licence to operate a pension fund). The purpose of state supervision, is to protect the participants' interests, both the security of their accumulated financial assets and, in individual cases, for instance, to ensure compliance with the supplementary pension scheme agreement.

State contribution

The government makes a contribution to the pension fund, to add to the participant's contribution, from the state budget. The minimum monthly amount of the state contribution is CZK 50, where the participant pays a contribution of CZK 100. The maximum co-contribution is CZK 150, where the participant pays CZK 500, or more. A participant can obtain a maximum of CZK 1 800 annually, as a state contribution (compared with certain other types of savings, where the maximum state contribution represents CZK 4 500, yearly).

At the beginning of the system, in 1994, state contributions were lower, but they were increased by 25%, during its first two years. Legal changes, adopted in 1999, which amended the Law on Supplementary Private Pensions, and which came into effect on the 1 January 2000, laid down that contributions would remain, permanently, 25% higher. The state contributions have not since been adjusted.

Tax allowances

Tax allowances are available to pension funds, to offset against the returns from their financial activities, so, in fact, most pension funds pay insignificant amounts of, or no, income tax.

Tax allowances were introduced, with effect from the 1 January 2000, for fund participants, and for employers, who pay contributions for participants:

a) Each participant, who has paid more than CZK 6 000 in contributions in a year, can deduct the amount above CZK 6 000 from their income tax base. For example, a participant who has paid a monthly contribution of CZK 1 700, will be provided with a state contribution of CZK 500, and can deduct CZK 1000 from the tax base, but for the remaining 200 CZK there are no further benefits provided by the state.

b) Contributions can be paid on behalf of, and with the agreement of, the participant − employee by the employer. The contribution paid by the employer to a pension fund, has the following tax allowances:

- The contribution can be included in the employer's costs, up to the amount of 3% of the assessment base of the participant-employee, for social insurance, and for the state employment policy contribution.

- The employee is not taxed on income, arising from the contribution paid by the employer, up to a sum equal to 5% of the employee's assessment base, for social insurance, and for the state employment policy contribution.

- The tax allowance related to the participant – employee's income, motivates the employer to pay a contribution which, in size, corresponds with the amount of the wage. In view of the fact that the supplementary retirement income should be a substitute for the previous income received from employment, the link between the amount of contribution, and the amount of income, is logical.

Allowances for the payment of insurance for the mandatory insurance

The contribution for the supplementary private pension scheme, with the state contribution, paid to an employee's pension fund account, by an employer, is not included in the assessment base, for the above-mentioned types of mandatory insurance.

Currently, there are a total of 14 private pension funds in operation, of the original 44 private pension funds. The number of pension funds decreased, as a consequence of their consolidation into larger entities, with 11 funds being liquidated. The number of participants in the dissolved funds, who have had their benefits affected, represents 1% of the total of 2.5 million participants. Further liquidations are not envisaged, though further consolidation of pension funds is expected. The average age of participants has remained at 48 to 49 years.

Foreign shareholders have gained a strong majority position, in many pension funds. The volume of assets, in the pension funds, exceeds CZK 55 billion. To date, the participants have received CZK 14 billion in state contributions; in 2001 alone, these were close to CZK 3 billion.

The composition of pension funds portfolios includes bonds (57%), treasury bills (23%) and stocks (8 %). The average investment results achieved range closely around the inflation rate, maintaining the real value of the money deposited.

The main concerns for the current supplementary, private, pension scheme, with a state contribution, include:

- Insufficient security of the funds deposited, caused mainly by the fact that the activities, and intervention of state authorities, are diffused, and slow.

- Insufficient transparency of management, as a result of the nature of the separation, of the financial assets of the participants, from those of shareholders.

- High operation costs, mostly as a consequence of the individualised (open), nature of the system.

– The short-term character (so far) of the supplementary private pension schemes, that serve, rather, as a convenient means of savings, and not as a method of old-age security.

One of the aims of the amendment to the Law on the Supplementary Private Pension with a State Contribution, was to improve the current situation of such funds. This was to be done, mainly, by increasing the stability and safety of the system, as well as improving the effectiveness of state supervision. The alterations made can be characterised as necessary changes, to the current legal regulation, due to both EC requirements, and the practical experience gained from operating the state supervision requirements. The proposed changes were, mainly, aimed at:

– Increasing the transparency of the management of the pension funds, by the separation of the pension fund's assets from the assets constituted by the participants' contributions, the state contributions, and the returns coming from these contributions.

– Increasing the cost-effectiveness of the management of the participants' assets.

– Expanding the investment opportunities of the pension funds.

– Making state supervision stricter, and strengthening the role of public control.

– Harmonising the framework of legal regulations, with international law, international treaties, and EU legislation, in association with entry into the EU.

The draft was rejected in October 2001, by the Czech parliament, and a new draft can be prepared only after the election in June 2002.

Characteristics of the newly prepared supplementary occupational pension scheme

At the beginning of October 2001, the government submitted to the parliament, after more than two years' preparation, the draft of the Law on Occupational Pension Funds. In December, the parliament rejected the draft, so the next attempt at passing this law can only be tried after the election, *i.e.* not before the end of 2002.

In the Czech Republic, the necessary conditions for the development of closed-end occupational supplementary pension schemes, functioning on similar principles, have not yet been created. The existing system of the supplementary, private, pension schemes, with a state contribution, and several products offered by insurance companies, are using the tax advantages, which exist for contributions paid by employers, for the benefit of individually concluded agreements, with employees who are the clients of companies (pension funds, insurance companies). This system, however, does not make use of all the advantages of the European model of occupational pensions. The current system must ensure financial benefits, for the participants in the supplementary, private, pension scheme, whom companies must individually win into joining, and keep in a fund, at a high cost, in a competitive environment. It must also be economically viable for the pension funds' owners, who will have invested considerable financial resources into the pension funds' operation, and who expect profits corresponding to the returns on their financial investment. When compared to the West European and American occupational pension systems, which do not compete with each other, the following characteristics of the current pension funds emerge. The tendency of the market to be concentrated in several large pension funds, controlled by foreign financial groups, which results in similarities in the benefits received, and in terms of investment strategies. And at the same time, the system lacks transparency for individual contributors, as this is prevented by the competitive nature of the system, and by the requirement for the protection of the business interests of the pension funds shareholders.

The draft, submitted to the parliament, of the Law on the Occupational Pension Funds, was based upon the experience of the EU Member States, the US, and other developed countries. It regulated conditions for the establishment, and development, of the occupational pension funds system, operated by non-profit pension companies, and established by employers, through occupational pension funds, administered by them, but separated from them, in terms of accounting. It also regulated the operational, and investment activities, relating to the administration of occupational pension funds, and established the supervision of them by the state.

The objective of the introduction of the new supplementary pension system was not to create a substitute for the existing systems (private pension open funds system, with a state contribution, life insurance). The objective was, rather, to complement the range of pension fund schemes, with those of the occupational pension funds, which are a standard worldwide. The importance of private, supplementary, pension savings, as an income source for retired citizens in the ageing Czech population, will necessarily have to increase, as is demonstrated by the Concept of the Continuation of the Pension Reform, approved by the government on 2 April 2001. Therefore, it is vital to introduce all proved, effective and safe types of pension schemes. In countries with a developed market economy, the significance of private supplementary pension systems has been growing, and forms the most fundamental element of pension systems.

The reason for the wide use of occupational pension schemes is their connection to the employment relationship, and the comprehensive care that an employer should provide for his employees. This comprehensive care is the result of a social dialogue within a company, and its specific form is negotiated, within the collective bargaining system, on a company, or sector, level. The occupational pensions represent, in this regard, deferred wages, protected by the wage protection system, and guaranteed by the laws relating to the employment relationship. The guarantees of the system by employers, the ease of communication by the pension fund custodian, with the employer, and the non-profit nature of this pension system, create very favourable conditions for promoting its transparency, its cost-effectiveness, and safety, from the point of view of the employees. The proposed occupational pension system sought the maximum simplicity, safety, effectiveness, and transparency. It would have been, in many ways, different from the fundamental principles of the current, private, pension fund schemes, with a state contribution.

Occupational pension schemes were to be financed only from the contributions of the employees, and their employers, and from the returns obtained by the group investment of these contributions, through qualified external custodians.

Occupational pension funds were not to be subject to commercial trading (*e.g.* takeovers).

Competition costs relating to winning members into pension schemes, mainly through dealers, were not to exist in the occupational pension funds system.

The pension companies' priority was to be the interests, and needs, of the participants, in obtaining the maximum long-term returns for them, and not the short-term interest, in profit, of the owners of a joint stock company This aim was evidenced, by the fact that such occupational pension schemes do not allow for early withdrawals of the asset, which are intended to provide the old-age income.

Pension companies were to be permitted to administer more than one occupational pension fund each, which would allow for achieving cuts in operational costs, when compared to the concept of one custodian, one pension fund. (The idea was that an employer was to be able to offer employees a range

of pension schemes, which would differ, both in terms of the benefits offered, and in terms of the investment strategy.)

Only defined contribution pension schemes were to be allowed, and portability of the funds' assets was to be ensured. This meant that, on a change of employment, an employee could take their assets to a new employer's pension fund, thus ensuring that labour ability would not be impaired.

Employee representation would have a significant role, in the activity of the occupational pension funds system. Employees were to be the owners of their pension savings, that were to be entrusted into the custody of a pension company. They would participate in decision-making about the management of the savings, through their elected representatives, on the pension companies' bodies.

The establishment, and operation of, an occupational pension fund, was to be the subject of collective bargaining (mainly in relation to decisions about the amount of contributions, which in fact represents deferred wages).

The new system would have the minimum of administrative requirements, both in relation to the pension companies, or the external custodians managing them, and in relation to state supervision. Matters relating to the individual collection of contributions, and to the processing of claims for the state contributions, business activities, associated with winning members for the fund, and relationships to dealers, advertisement agencies, and the like, were to be eliminated. Due to its lower operational costs, the system should have enabled participants' assets to grow faster, leading to higher supplementary pensions. This is the long-term experience of countries, with the strongest private pension systems.

The operation of occupational pension funds was to be transparent, and to be consistently separated, in legal and accounting terms, from their founders, and their operational and investment custodians.

The nature of the individual accounts, in a fund, would have accurately, and continuously, given a true picture of the value of the fund's assets belonging to each individual participant (which would have depended on the amount of contributions paid by the participant and their employer). This would have contributed to the system's transparency.

Operational costs of the funds were to have been transparent, as fees for the funds' operational and investment administration, would have been defined by the law. They would have been paid from the assets in the occupational pension fund, and their amount was to be limited, as no fees, other than those defined by law, could be charged to an occupational pension fund.

The participants would have had easy access to information on the pension fund's activities, and on its benefits, through the pension company administering the pension fund, through their employer, or through the trade unions, of which they are members. Participants would also be able to request explanations, without delay, from their pension company representatives, whom they would meet daily, at their workplaces.

External investment administration, through state authorised investment custodians, which was to have been mandatory for the occupational pension funds, would have contributed to the security of the pension savings, to higher professionalism in their management, and to achieving higher returns for the participants. The founders of the pension companies, their internal committees, or the members of such bodies, would not themselves be able to invest the assets of the occupational pension system.

Occupational pension funds would have contributed to competition amongst investment custodians, who were to be forced to offer their services, at advantageous prices, and to prove their long-term investment achievements, in the administration of a conservative portfolio, in the sphere of supplementary pension systems.

The occupational pension funds were to have been able to use, if they wished, for the purposes of paying out benefits, the services of external entities, *i.e.* insurance companies and pension funds, providing pension schemes, with a state contribution, and, in this way, they would contribute to the development of the annuities market, in the Czech Republic.

The occupational pension funds would have contributed to social programmes of successful companies, where they would have strengthened the company's team spirit, and helped in the sphere of collective bargaining.

Among the fundamental changes they were to bring about, as compared to the private pension fund schemes, with a state contribution, and life insurance, was the use of a non-profit legal entity, for the purpose of occupational pension fund administration. This development was based upon international experience. The elimination of competition, during the process of enrolling participants, and distributing returns from the contributions invested, markedly decreases the costs, and increases the returns of a fund, and, at the same time, improves the participants' benefits. Another fundamental change, was to be the competition between the external investment custodians of the pension funds, from which participants would clearly have benefited.

The occupational pension system was to be operated by an independent legal entity, a pension company, separated, in terms of accounting, from the pension fund, that would represent the volume of the participants' pension savings (employees' and employers' contributions, and returns), and from its founders.

The non-profit nature of the administration, and distribution of the returns of the fund, would have guaranteed that investment returns would only be used for financing supplementary pensions. This would have meant, that the costs of creating a pension in an occupational pension scheme, would be lower than, for instance, those of creating one through a private pension fund, with a state contribution. The pension fund was to be administered by representatives of employers, employees, and pensioners, sitting on the internal committees of the pension company. They would decide on all major issues, mainly with regard to the fund's management, the selection of investment custodians, decisions about investment strategy, and the distribution of returns. The actual expert activities, most of all the investment of financial assets, were to have been carried out, for an agreed fee, by the external custodians, who would regularly have presented the results of their activity, to the pension company's committees. If their results were not satisfactory, they could be replaced. Occupational pension funds were to be separated from employers, who would not have the chance to make decisions affecting them, nor to misuse their financial assets. Investment, into the firms of the founders of the occupational funds, was to be largely restricted by law.

A competitive environment was to be applied, mainly in the sphere of operational, and investment administration, where, as mentioned before, it would have resulted in cutting down costs, and thus in higher returns, for participants. Competition would not have been permitted, in relation to enrolling participants, as competition markedly increases costs (dealer services, business units, advertisement, and the like), and represents a burden on the funds, not only for the current year, but, also, for the future.

A special tax regime, relating to employees' and employers' contributions, to returns from the financial management of the pension funds, and to the paid benefits, similar to that of the "private pension funds system, with a state contribution" was proposed, in order to support occupational pension funds. The state would control the activities of the occupational pension funds, through supervision. State supervision was to be founded, on the same principles as that of the "pension funds with a state contribution", in compliance with the Act No. 42/1994. State supervision was to be carried out by the Ministry of Finance, and the Securities Commission.

Based on experience from other countries, the proposed system provided conditions for operating occupational pension funds, with a minimum of administrative staff, and a minimum of costs, so that, if an employer ceased to exist, or an employee changed employment, this would not threaten the occupational pension fund, or the participants.

It was assumed, that only large employers, or groups of employers (in developed countries there are often sector pension funds) who were successful, and had the prerequisites for long-term economic development, would found independent, occupational pension funds.

Private insurance

Pension insurance is provided by private insurers as a part of life insurance (which also provides other forms of life insurance, endowment insurance, whole-of-life and endowment assurance, investment insurance). Provision for-old age may be taken out in the form of pension insurance or endowment insurance. The latter, however, is often taken out (under a different name), to ensure the security of children.

While supplementary, pension insurance, with the state contribution, managed by pension funds, is designated as a provision for members' old age, private insurance covers a whole range of insurance claims, of which old age is only one. Insurance policies, commonly, combine various insurance claims, and it is only possible to separate out the pension products designated for old age with limited accuracy. These products are currently covered by insurance contracts, concluded between a beneficiary of insurance, and an insurance company.

Insurance companies offer many variants of pension insurance. Such insurance usually contains a provision for a life annuity ,to be paid from an agreed date of termination of insurance, for a temporary pension, to be paid, in the event of full disability, or from the date of the termination of insurance, for a bereavement pension, for exemption, from payment of contributions, in the case of full disability, while maintaining all entitlements from insurance, a share in profits, even after the beginning of payment of a pension, the return of contributions, paid in case of death, before the end of the qualifying period.

Instead of regular payments of an annuity, the policyholder has the option of taking the amortised value of the pension, in one lump sum, including a share of profits, of deferring the start of payment, or of choosing a shorter period of payment (when a higher pension is paid). The employer has the option of concluding a collective pension insurance agreement, on behalf of his employees.

In 2001, tax allowances have been extended, to insurance products designated as the old-age provision of private insurers. The tax allowances do not apply to collective insurance − *i.e.* policies signed by the employer, as policyholder with the insurance company, for the benefit of employees.

The higher premium rates of private companies imply that their clients come mainly from middle and high-income groups. For such persons, private life insurance may be an effective way of providing a supplementary income, in old-age.

Table 17.1. Proposed target structure

Parameter	First pillar:	Second pillar:	Third pillar	
	Pension insurance	Occupational supplementary scheme	Open supplementary scheme	Private insurance
Guarantee by the state	yes	no	no	no
Extent	all economically active persons	groups of persons by occupation	individual	individual
Participation	obligatory	voluntary	voluntary	voluntary
Financing	PAYG	fully funded	fully funded	fully funded
Relation of contributions and benefits	alternative 1: DB alternative 2: NDC	DC	DC	DB
Amount of benefits	alternative 1: based on the period of insurance and achieved income alternative 2: based on the amount of contributions paid and individual lifetime (regardless of sex)	based on the amount of contributions paid	based on the amount of contributions paid	based on the amount of contributions paid
Solidarity	between generations and income groups	none	none	none
Tax deductions	yes	yes	yes	yes
Contribution by the state	Tax deductions	no	yes	no
Administration of the system	Government	private	private	private

Source: Author for the OECD.

Supplementary Pension Insurance in the Czech Republic
(Statistical Data)
1994-2001

Figure 17.1. Number of pension funds

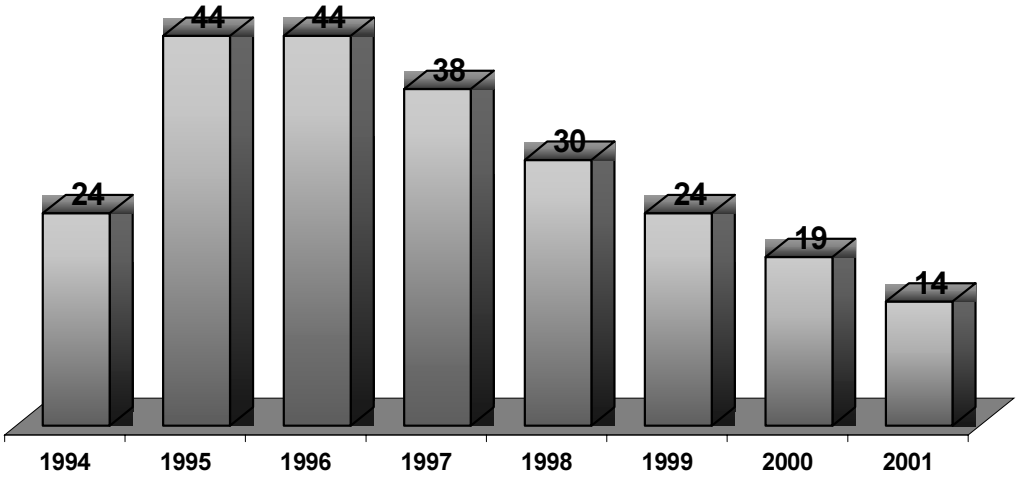


Figure 17.2. Public funds assets

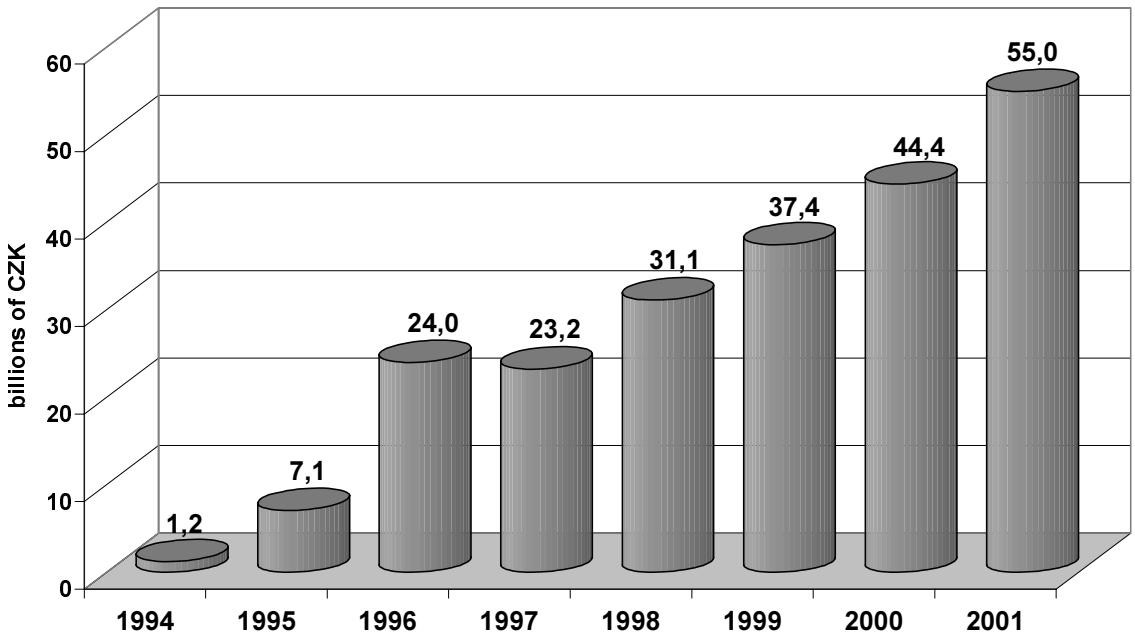


Figure 17.3. Number of participants

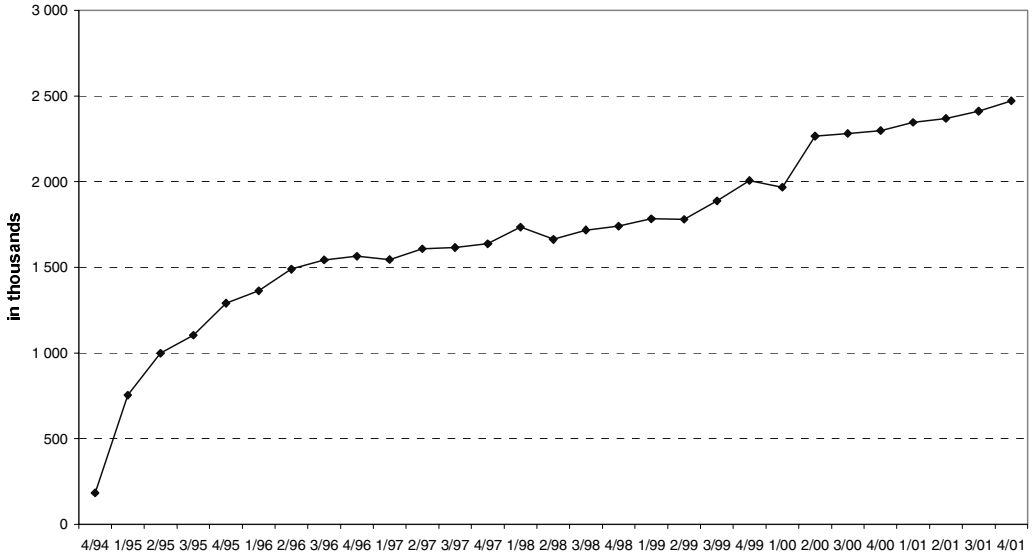


Figure 17.4. Income and expenditure of pension funds

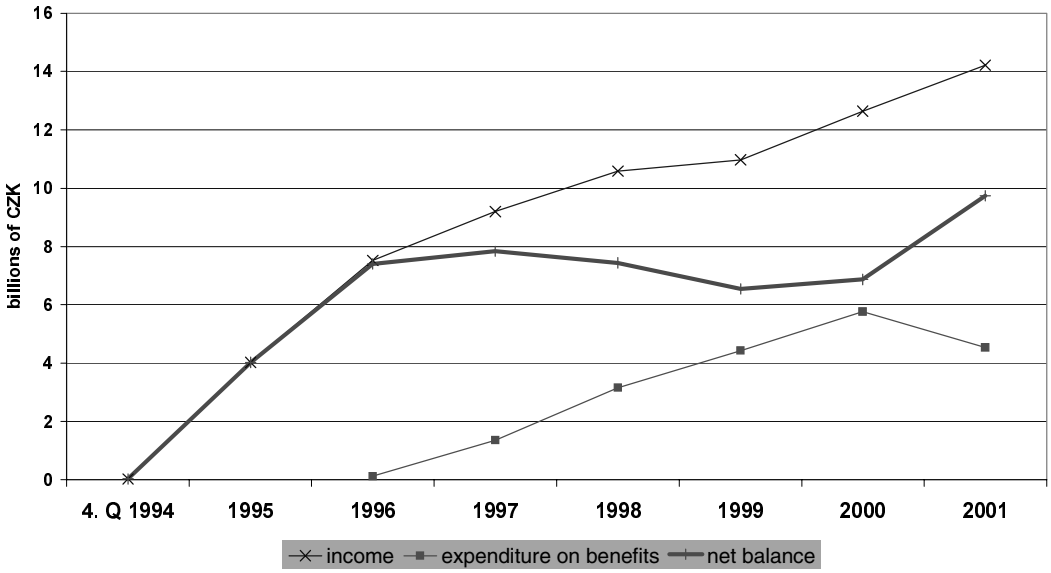


Figure 17.5. Development of average monthly contribution

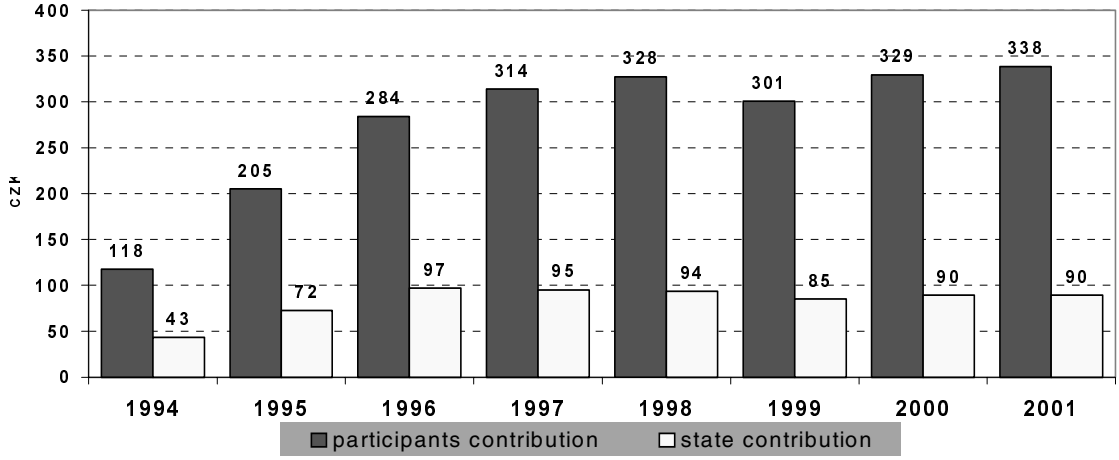
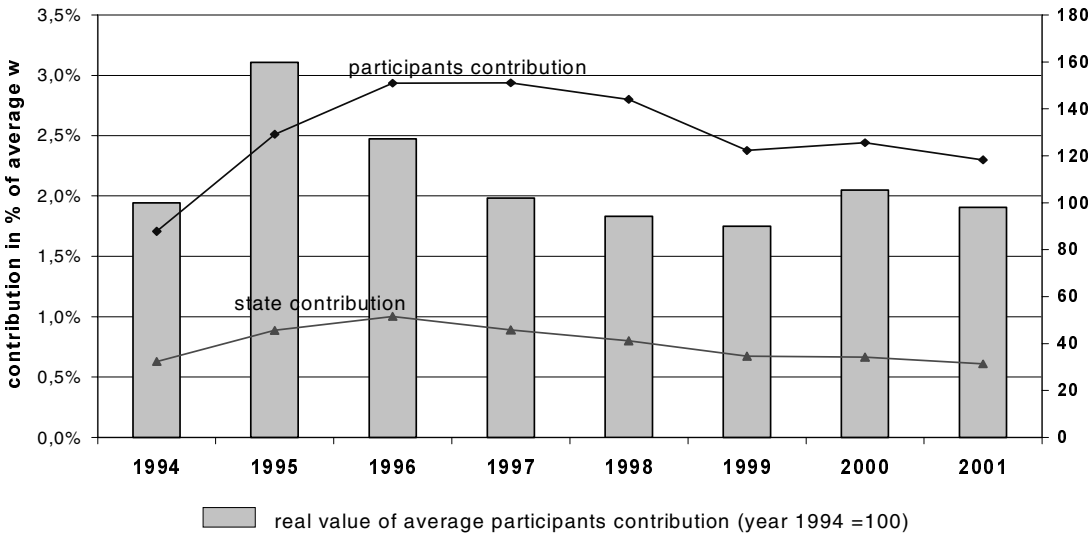


Figure 17.6. Development of real value of average contribution and of ratio of average contribution to average wage



Chapter 18

CONTRIBUTION EVASION: IMPLICATIONS FOR SOCIAL SECURITY PENSION SCHEMES[1]

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Introduction

Failure of participants to comply with their contribution obligations to social security schemes, is a problem which threatens the legitimacy of the schemes, the adequacy of the social protection of persons whose due contributions have not been paid, and the financial viability of defined benefit schemes. If widespread evasion results in generally inadequate pensions, governments may be obliged to supplement them. While evasion is a serious problem, it receives little attention in the social security literature. Generally, evasion of contribution obligations, by employers and workers, is illegal, hence, statistics on evasion are rare, and evidence is principally anecdotal, or derived from other data. Avoidance of contributions, for example, by seeking early, or disability, retirement, or employment that is not covered by the scheme, is legal. High levels of evasion, and avoidance, can indicate low public credibility of a social security scheme, and reflect on the quality of governance of the scheme, and the efficiency of scheme administration.

It is important to distinguish between coverage − those persons who, by law or regulation, are participants in a social security scheme, and are generally obliged to contribute to it − and compliance, which refers to the extent to which covered persons meet their contribution obligations. A social security scheme can only function with the support of its participants (Rofman and Demarco, 1999, p. 2). Extending mandatory coverage to categories of workers, who may not be disposed to participate in the scheme (*i.e.* to contribute), and whose participation cannot be effectively enforced, may bring political rewards, but it can bring a scheme into disrepute, if their participation is illusory. Typical examples of these categories include self-employed workers (including farmers and fishermen), and domestic workers. If evasion of contributions becomes widespread, and is tolerated, a mandatory social security scheme can effectively become a voluntary scheme. This paper focuses on compliance of employed persons. Compliance of self-employed workers involves additional, and more complex, problems. For a summary of these, see ILO (2000, pp. 198-199).

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1. Reprinted with permission from the *International Social Security Review*, Vol. 54, No. 2, October-December 2001. Based on a paper presented to the Third APEC Regional Forum on Pension Fund Reform, Bangkok, 30-31 March 2000.

For employed persons, social security contributions are, normally, withheld from their wages by their employers, who are legally responsible to remit the contributions, along with any employer contributions, to a collection agency. Employers are subject to penalties, if they fail to make the remittances within specified time limits. An employee's evasion of social security contributions normally requires collusion with the employer and, sometimes, the employer colludes with social security scheme inspectors.

In social security schemes where employers contribute, there is an incentive for an employer not to contribute, in order to reduce labour costs. When the employer opting for this approach is the government or a state enterprise, the demonstration effect encourages other employers to follow the example set by the government. The principal incentive for workers to evade contributions, is to increase their disposable income. Evasion of social security contributions is possible, if the social security organisation tolerates evasion, or if it does not have the authority, or the resources, to enforce compliance with the statutory contributory provisions. The problem of evasion warrants greater attention, as does the development of strategies to promote compliance.

Principal types of evasion

Employers can evade contributions, by under reporting employees who should be covered by the social security scheme, for example, by designating employees as workers who are not required to contribute (*e.g.* casual, part-time, or temporary workers, or contractors), thereby informalising them. They can also evade their contribution liability, by under reporting the earnings subject to contribution of workers, whom they have registered with the scheme. Employers can delay remitting contributions to the social security scheme, contrary to the scheme regulations; or, in the most insidious case, employers can fail to remit contributions, which they have withheld from their employees.

Provisions of a scheme may facilitate evasion. For example, an employee may claim to be self-employed, if coverage of self-employed workers is voluntary. Where employers must have a minimum number of employees (or turnover), for coverage under a scheme, they may contrive to keep the number of employees below this number. Social security cash benefits are designed to replace a portion of the regular income of a worker, and it is this regular income, on which contributions are based. The portion of regular income, in a worker's wages, can be reduced by exaggerating overtime compensation, and allowances (*e.g.* for travel).

Workers may avoid contributions, by opting for early retirement, or seeking a disability pension, or by working in the informal sector, which is not covered by social security. This can result in labour market distortions, and a loss of potential domestic saving (Manchester, 1999, pp. 296-299). In many countries, especially those with high unemployment, it is not clear that avoiding social security contributions, and other taxes, are sufficient inducements to joining the informal sector, given the typically uncertain income, and dubious security, of informal sector employment.

Reasons for evasion

Aside from seeking to reduce their labour costs, employers may evade paying social security contributions, due to the administrative complexity of compliance procedures. Separate contribution assessment, and collection arrangements, for different social security benefits (and for income tax), and multiple collection agencies, to which contributions must be allocated, and remitted, make compliance more difficult, and evasion more attractive, and practicable. The records of some employers, especially in small establishments, are sometimes inadequate for them to determine the contributions payable. The proclivity of an employer to evade, also depends on the employer's

assessment of the risk of being caught, and should the employer be caught, the severity of the consequent financial penalty ,and damage to the employer's reputation.

Current consumption needs can lead workers to seek to evade paying social security contributions, especially when the contribution rate is high. Poverty, temporary financial hardship and, particularly for young workers, expenses associated with family responsibilities, are more immediate, and pressing, than paying contributions for a future retirement benefit.

Myopic behaviour − placing too low a value on future retirement consumption needs − led to state intervention to set up retirement benefit schemes, both to avoid the consequences of inadequate provision for retirement by myopic individuals, and the burden which they would create for prudent persons, who, in a modern state, would be called upon to support them (Thompson, 1998, p. 28). Myopic behaviour is reinforced, when individuals perceive that they are unlikely to survive to receive retirement benefits, or when inflation discourages saving. Such short-sighted behaviour, and current consumption needs, can provide strong motivations for workers to evade their contribution obligations (World Bank, 1994, pp. 319-320).

Some defined benefit schemes contain design features that encourage evasion. For example, in the 1970s, one public scheme (which eventually became unsustainable), provided an old-age pension at age 65, after ten years of contributions, equal to 50% of the highest three years' earnings (adjusted for cost of living inflation) after age 55, and the pension was increased by 1% for each year of service after ten. Five of the years of service had to be in the eight years prior to retirement. Thus, after ten years of contributions, the increment in the pension was marginal. The scheme was open to strategic manipulation by workers, who could organise their employment to maximise their expected pensions, and minimise their contributions, and this was reflected in high rates of contribution evasion.[2]

In defined benefit (DB) pension schemes, the retirement pension is often calculated according to a formula, which links a worker's earnings near retirement, and the period during which the worker contributed to the scheme, hence, the link between benefits and contributions is not transparent in many DB schemes. In defined contribution (DC) schemes, the periodic payments throughout retirement, depend on the accumulated amount in a worker's individual account at retirement. It is expected that the close link between benefits and contributions, in DC schemes, will reduce contribution evasion, since evasion directly results in lower pensions (James, 1998, p. 455). This rational response does not seem to be reflected by high levels of compliance in DC schemes, which have replaced DB schemes (Schulthess, 1998, p. 139; Mesa-Lago, 1998, p. 782; Holzmann *et al.*, 1999, p. 9). In Gillion *et al.* (2000, p. 255) it is noted that, in several countries in South America, only around half of the labour force participates in the mandatory DC scheme. Myopic behaviour, and current consumption, needs still seem to predominate over prudent saving for retirement.

Government minimum pension guarantees can create a moral hazard, for contributors who may decide to forego contributions, in order to take advantage of the guarantee. Eliminating a guaranteed minimum pension would remove the potential moral hazard, but would not solve the problem of providing retirement income support for persons whose pensions, for whatever reason, are low.

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2. One reason for basing benefits on final average earnings is simplicity of administration. Before modern information technology methods were introduced, maintenance of annual records of contributory earnings over a participant's entire working career was beyond the administrative capacity of many schemes. In some DB schemes that require extensive historical records in order to calculate a benefit (and in some provident funds), a retiring participant is expected to produce his/her own service (or contribution) records when applying for a benefit.

Workers may try to evade their contribution obligations, if they lack confidence in the social security scheme, for example, if the legitimacy and equity of the scheme are being challenged. A few workers will reckon, and others may be persuaded, that they can obtain a better rate of return on their contributions elsewhere, thereby encouraging them to evade. If evasion is widespread, and creates little opprobrium, and enforcement is weak, evasion becomes an easy option. Even if workers wish to comply with the contribution conditions, they may be reluctant to report a defaulting employer, since, if their anonymity is not maintained, the worker risks retaliation (loss of employment), and if enforcement is weak, reporting the employer may be futile.

Effects of evasion: why governments should care about compliance

Evasion creates inequities between employers, who meet their contribution obligations, and those who do not, and, similarly, between workers who contribute, and those who do not. The effect of evasion on the solvency of DB and DC schemes differs. When evasion is due to an employer failing to remit contributions withheld from employees, in most DB schemes (but not DC schemes), participants who have been defrauded receive credit for the service and earnings represented by the contributions, whether the scheme can recover the contributions from the defaulting employer, or not. In a DB scheme, evasion can result in lower *real* replacement rates, and/or a higher contribution rate, than would otherwise be required to pay pensions. When earnings are under reported, the benefit formula, and/or minimum pension provisions, can produce deceptively high replacement rates, relative to reported earnings. A DB scheme (*i.e.* its current and future members), and ultimately the government, bear the risk that evasion will result in insufficient income to pay benefits, and that a transfer from general revenue will be necessary. This may motivate social security organisations, and governments, to enforce compliance with DB scheme contribution conditions. This motivation is not present in DC schemes.

In DC schemes, individual participants bear the risk that their benefits will be inadequate. Evasion results in lower periodic payments during retirement, but neither the scheme (nor account managers), nor the state, is legally responsible for this result of evasion. However, the consequent recourse to general revenue financed minimum pension guarantees, and political pressure from retired persons, will, surely, make it inevitable that the state will be called upon to provide retirement income support. Increased attention to enforcing compliance can reduce this potential burden.

Minimum pensions

In some countries, members of DC individual accounts schemes are guaranteed minimum pensions by the government. Whenever necessary, pensions of participants who have contributed for a specified minimum period, are supplemented, up to the level of a guaranteed minimum pension. Table 18.1 indicates minimum pension provisions in selected countries.

In Chile, where after 20 years of contributions, the minimum pension is around 25% of the average wage, it is not clear that the minimum pension guarantee provides significant inducement to evade contributions. However, participants may decide to rely on the minimum pension (presumably, along with other savings), to finance their retirement, or they may conclude that continuing to contribute is not going to produce a pension significantly higher than the minimum pension. Arenas de Mesa (1999, pp. 12-14) estimates that 52% of pensioners in the private DC individual accounts system in Chile, will qualify for minimum pension supplements, and that the cost of minimum pensions will rise from around 0.04% of GDP in 1999 to 1.3% of GDP in 2037.

Minimum pensions are paid from general revenue. There is no pooled fund from which they may be paid, as in a DB pension scheme. Arenas de Mesa (1999, p. 33) proposes establishing a pay-as-you-

go (PAYG) DB scheme to finance minimum pensions. If a significant proportion of retired persons are receiving minimum pensions, the increasing number of pensioners, and their political influence, can lead to irresistible pressure on governments, to increase the levels of minimum pensions.

Another potential result of evasion, is that workers may be obliged to delay their retirement (provided, of course, they can find employment), not because they wish to continue working, but because their DC scheme pensions are too small to support them, and their dependants. Contribution evasion may thus lead to an increase in the age when workers withdraw from the labour force, a desirable result (albeit for a perverse reason), in countries where significant reductions in the labour force, relative to retired persons, are projected. The affected workers will have employment income while they continue working, and the retirement period, during which they must rely on their pensions will be reduced, thereby resulting in larger pensions.

Measuring evasion

Workers' evasion is generally considered to be greatest among self-employed workers, and young, low-paid, domestic, casual and part-time workers. Evasion of contribution obligations is normally illegal; consequently, consistent data on the extent of evasion by participants (or workers who should participate) in a scheme, are not available. Evasion is prevalent among small employers, employers in the informal sector, and employers who are experiencing financial difficulties, categories for which reliable statistics are difficult to collect. A social security scheme usually has statistics on the number of registered employers contributing regularly to the scheme. Among the types of evasion by employers registered with a scheme are: i) failure to register eligible workers, ii) under reporting earnings, and iii) delay in remittances, or failure to remit. The scheme will normally have data only on collections, the third item.

If the coverage of a scheme is broad, an estimate of the amount of contributions which have been evaded, the contribution gap, can be made by taking the difference between the contribution income received, and the product of i) the estimated annual average number of employed persons times, ii) the estimated annual average covered wage times, iii) the contribution rate.

Employers' compliance with contribution regulations, in countries where contributions are collected along with income taxes (*e.g.* Canada, US), and in Japan, where social security contributions and taxes are collected separately, is considered to be high. In the US, the total contributions not paid voluntarily as a percentage of the estimated "true" liability, was estimated to be 10.3% in 1997. For employed persons, the percentage was 4.2%, and for self-employed persons, it was 58.7% (Manchester, 1999, pp. 302-303). In Japan in 1996, 98.6% of employers who were required to contribute to the scheme covering employees, did so. On the other hand, in 1997, 7.5% of those who should have registered with the scheme covering self-employed, and unemployed, workers, failed to register, and 8.2% of those who had registered, had not contributed in the past two years (Gillion *et al.*, 2000, p. 253).

In 1996, the Singapore Central Provident Fund, which collects contributions directly, reported that the default rate for employers, who failed to pay the monthly contributions on time, was 1.4% (Central Provident Fund Board, 1996, p. 43). In 1996 and 1997, the Employees Provident Fund of Malaysia reported that the percentage of defaulting employers was 4% (Employees Provident Fund, 1997, p. 22).

In the Russian Federation, where the financial crisis in mid-1998 exacerbated structural crises associated with economic restructuring, Cichon (1999) estimates that the contribution gap of the Pension Fund of the Russian Federation grew from 26% of contributions, due in 1997, to 53% in 1998.

Table 18.2 shows statistics on the ratio of contributors to participants (affiliates), for several reformed schemes in Latin America. These statistics reflect a number of factors, of which compliance is only one, and they must be interpreted cautiously (Mesa-Lago, 1997, pp. 420-421). The following caveats should be borne in mind:

- Participants may have withdrawn from the covered labour force, yet may still be included in the potentially active participants. Clearly, if participants who have withdrawn from active coverage are considered to be eligible contributors, the ratio of contributors to participants will decrease. Failure to remove participants who have become inactive, can eventually lead to the number of participants exceeding the labour force. [See Arenas de Mesa (1999) with respect to Chile.]

- In individual accounts DC schemes, participants may be registered with more than one pension fund manager, and administrative problems may complicate identification of participants (especially those who switch managers), and employers may delay remitting contributions.

- Self-employed participants, who are obliged to contribute, have notoriously low compliance rates. If self-employed workers are a significant portion of the covered labour force, this can result in a low overall compliance rate. Queisser (1998, p. 107) reports that in Argentina, where self-employed workers are obliged to contribute, 70% of them failed to comply.

Schmidt-Hebbel (1999, p. 10) observes "... coverage of affiliates – that comprise both active contributors, and non-active members – is very different from coverage of contributors. The latter number ranges from a half to two-thirds of affiliates. The causes of this discrepancy include varying degrees of evasion of contributions, large and time-varying degrees of labour informality, and large variations in the composition of the officially measured labour force, and people moving in and out of the labour force. A case in point is Chile, where 100% of the labour force is affiliated with the second pillar scheme, but only 56.2% are active contributors. In this country, most of the difference is due to independent, and informal, sector workers, as the ratio of active second pillar contributors to dependent workers [*employees*] is close to 90%" (italics added).

Arenas de Mesa (1998, Table 4) separates Chilean employed persons from the self-employed, for whom coverage is voluntary. In 1998, the ratio of contributors to employees was 66%, and for the self-employed, it was 4%.

It is clear that the definition of coverage and measurement of compliance can lead to statistical complications, and inconsistencies. The relationship between an individual's employment status and coverage, and the individual's obligation to contribute, can be summarised:

Employment status of individual	Contribution obligation
1. Covered:	contributor
1a. active participant	
1b. inactive participant	non-contributor (possibly can contribute under 2)
2. Voluntary coverage	optional contributor
3. Not covered	non-contributor
4. Pensioner	non-contributor

Inactive participants include persons who have temporarily, or permanently, withdrawn from covered employment (due, for example, to unemployment, retirement or, in the case of females, maternity), generally with acquired benefit rights arising from prior periods of active participation. Measurement of compliance refers to the ratio of contributors to active participants in category 1a.

Evasion and financial projections

Defined benefit schemes

While the true rate of compliance may be difficult to measure, it is clear that it is below 100%. In actuarial projections of contributions to DB schemes, this is taken into account by assumptions regarding the density of contributions where,

$$\text{Density of contributions} = \frac{\text{period during which contributions are paid or credited}}{\text{total potential period of contributions}}$$

This definition takes into account legitimate periods, during which a participant is not liable to contribute, evasion by the participant's employer, due to failure to register eligible workers, and evasion by the participant. If significant benefit rights are acquired in a DB scheme after relatively short contributory periods, a density of benefits which is higher than the density of contributions, can be applied. Different density assumptions can be made, by sex and type of employment. This definition of contribution density does not take into account under reporting of earnings subject to contribution.

An alternative density definition, which incorporates periods when contributions are not paid ,and under reporting of contributory earnings, is:

$$\text{Density of contributions} = \frac{\text{annual earnings on which contributions are paid}}{\text{annual earnings on which contributions are payable by a full-year contributor.}}$$

Defined contribution schemes

Estimates of DC scheme individual account balances are readily constructed, and there are no generally accepted standards regarding the assumptions which must be made concerning interest rates, and rates of wage growth during the active (contribution payment) period. Density is generally ignored (as is mortality), during the active period. Projections may be made over an active period of 40 years (*e.g.* age 20 to 60, or 25 to 65). Few participants will have a full 40 years of contributions and, consequently, the projected individual account balances at the end of 40 full years of contributions can be deceptive.

For example, in a DC scheme, assuming an average annual 2% real growth in wages, and 4% real interest earnings, after 40 full years of contributions, at a contribution rate of 10%, the balance in the account will be about six times the wages in the last year. Assuming an (arbitrary) annuity factor of 12 (*i.e.* 12 units, at retirement, produce a life annuity of one unit per annum), then the balance in the account results in a life annuity equal to 50% of the wages in the fortieth year. A greater difference between the assumed interest rate, and wage growth, will produce a larger annuity, and conversely. This relationship between the assumptions, and the fact that projections over 40 years may be

sufficiently robust for a group, but are unlikely to apply to any specific member of the group, are largely ignored. In this example, the effect of density of contributions is also ignored.

A worker who experiences intermittent periods of unemployment may have a density of contributions of 80%. If it is assumed that periods of unemployment are uniformly distributed over 40 potential years of contributions, then the annuity is reduced from 50 to 40% of the wages, in the fortieth year. But periods of unemployment are often concentrated, and prolonged. Suppose a worker continues studying, or cannot find employment, and does not enter the scheme until the ninth year, and thereafter contributes regularly for 32 years.[3] Again, the density of contributions is 80 %, but in this case, the annuity will be 37% of wages in the fortieth year. At the other end of a worker's career, if a worker contributes for 32 years, and is unemployed for the last eight years before retirement, the density is again 80%, but the annuity is 43% of wages in the fortieth year. While an 80% density of contributions may be a reasonable assumption for workers who experience involuntary unemployment, the density of contributions for workers who evade contributions can be very much lower. It is noteworthy that, while in a DB scheme which uses a final average earnings benefit formula, it is important to be in contributory employment during the period near retirement, so the earnings applied are high, in a DC scheme, the operation of compound interest makes it important to commence contributions early. [For a mathematical treatment of density of contributions, see Iyer (1999).]

Combating evasion

Evasion of social security contributions is not only a question of employers' seeking to reduce their labour costs, or workers' preference for current consumption, or the other factors heretofore mentioned. If social security organisations (and governments) rely principally on education and persuasion, to encourage compliance, rather than on effective enforcement, it is not surprising that contributors seek to evade their contribution obligations.

Social security organisations can combat evasion, but they must have the *statutory authority* required for effective enforcement of contribution conditions. If government does not grant a social security organisation the necessary authority, the commitment of the government to the social security programme is in question, enforcement will be hampered and ineffective, and benefit expectations will not be met. Social security schemes need:

- The *right to inspect* employer records, and unfettered access to ancillary information, such as an employer's bank statements, income tax returns, etc., from which estimates of the number of employees, and the wage bill, can be made, and compared to social security registrations, and contributions paid. Confidentiality should not be invoked, in order to conceal, or abet, evasion of social security contribution obligations; and

- The *right to assess and collect contributions due and unpaid, and assess enforceable penalties,* with social security debts having priority over other creditors, the possibility of attachment of employers' assets, etc.

Armed with statutory authority, social security organisations can take a number of steps to enforce compliance. They can *streamline administrative procedures,* by simplifying contribution regulations, and reporting and remitting procedures. Modern information technology facilitates this. Clearly, a unique registration number for each employer, and each participant, is necessary (however,

3. It is assumed that the worker's wages at entry are the same as those of workers who have been in the scheme for eight years. This is unlikely to be true in practice.

for worker contributors, this fundamental requirement causes many schemes much difficulty). Contribution conditions for different social security benefits, administered by different schemes, can be harmonised, and consolidated.

In some systems, workers have been empowered to make their own choices (*e.g.* select fund managers), but they, generally, do not have the information necessary, nor the capacity, to evaluate and analyse it, in order to make informed decisions. In their dilemma, there is no shortage of professional advisers, and salespersons, to assist them. The switching of fund managers, which results, complicates administration, and can create, or abet, non-compliance with contribution provisions.

According to Daykin (1998, pp. 36-37) "some would place a high premium on having consumer choice. It is difficult to be against choice, but the essential factor, with pensions, is to ensure that the consumer has adequate safeguards, since the issues are rather too complicated for most people to grasp fully the nature of the choices with which they are faced. Although it may sound paternalistic, it is sometimes better to limit the number of choices, in order to ensure that everyone receives a reasonable level of pension".

They can strengthen enforcement through focused, and timely, inspections. Effective enforcement requires timely verification of employer returns, and prompt investigation of possible discrepancies. There must be sufficient, well-trained, inspectors, who are adequately remunerated, so as to ensure their probity, and resources for them to undertake inspections. Enforcement activities are expensive, but they are a legitimate, and necessary, expense of a social security scheme. In Malaysia, at the end of 1997, there were nearly 300 000 registered employers in the Employees Provident Fund, and during the year, the Fund inspected just over 100 000 registered, and non-registered, employers (Employees Provident Fund, 1997, pp. 11, 22). In Singapore, 20% of employers' records are inspected each year (Wu, 2000).

They can initiate and enforce, punitive, but realistic, administrative penalties for evasion. Penalties should not be so severe, that they are unlikely to be respected, or applied successfully, or sustained by the courts. In the Philippines, 1997 legislation provides that non-registration of a self-employed person, failure of an employer to deduct the correct contributions, and remit them, or submission of a false claim for benefits, can result in six to twelve years imprisonment, and a fine (Social Security System, 1997, p. 29). The severity of the penalty leads employers, whose non-compliance is detected, to settle their arrears.

They can undertake public relations campaigns, to encourage compliance. Through the benefits they provide, and the efficiency of their operations, DB schemes must convince workers that, despite allegations that they are unsustainable, they are reliable providers of retirement income. A punitive approach, which in some countries has promoted compliance, is publicising (and prosecuting), employers for evasion (or maintaining the threat to do so).

They can report regularly (annually at least) to workers on contributions paid by them and on their behalf so that workers can verify that their contributions have been properly remitted and recorded, and at the same time they are reminded of the benefit rights they are acquiring.

They can collect pension scheme contributions, along with contributions for other social security benefits, for example medical care, for which the needs of workers, and their families, are more immediate; hence workers are more likely to comply, than for retirement benefits alone. In Germany, which does not have a serious evasion problem, pension contributions are collected by the sickness insurance funds. This procedure can increase administrative efficiency, and reduce employers' reporting burdens.

They can enforce compliance, indirectly, through realistic regulations which, while not inhibiting commerce, require that an employer be certified by the social security scheme, to be in good standing before the employer can be issued, or reissued, a business licence, bid on government contracts, receive an export licence, etc.

They can remedy scheme design deficiencies, that encourage evasion. For example, DB schemes can modify provisions, that encourage strategic manipulation of contributory periods, in order to maximise benefits, and minimise contributions.

They can co-ordinate verification, and enforcement activities, with the tax collection agency, where there are separate social security and income tax collection agencies.

They can declare amnesties, to encourage evading employers to comply in the future. In the Philippines, the Social Security System has offered several amnesties to delinquent employers, for example, from May to November 1997 (Social Security System, 1997, p. 29). Frequent amnesty declarations may not promote compliance, since employers may continue to evade, in anticipation of a subsequent amnesty.

It is noteworthy that the Singapore Central Provident Fund, which has, in effect, adopted a policy of "zero tolerance" of evasion, employs many of these methods, to achieve its enviable record of contribution compliance (Wu, 2000).

Social security schemes can avoid creating expectations, which cannot be fulfilled, and thereby bringing themselves into *disrepute by judiciously extending their coverage.* For example, extending compulsory coverage to self-employed persons seems to be a logical extension of social security, to a sector of the labour force that needs protection, and can have the capacity to finance it. But self-employment is not clearly defined, and, everywhere, persons deemed to be self-employed have notoriously poor records of compliance with social security contribution obligations.[4] Consequently, extension of coverage to self-employed workers can be futile, unless the categories of self-employment are carefully selected, and defined, and the administering body has the will, and the capacity, to enforce compliance. Unless an extension of coverage is implemented effectively, a social security scheme risks jeopardising its legitimacy.

Private DC individual accounts managers

With respect to contributions which workers are obliged by law to remit (through their employers), fund managers, to whom the contributions are payable, tend to behave in much the same manner as insurance companies, which receive premiums from persons they insure, and mutual funds (or unit trusts), which receive deposits from investors. In the case of insurance companies, the acquisition expenses for new policyholders are amortised over a number of years. Should a new policyholder cease paying the premiums due early in the contract period, the agent who sold the policy is debited the commission which the agent received. An insurance company's enforcement effort is normally limited to encouraging the agent to persuade the insured person to continue paying the premiums; a usually unsatisfactory endeavour, since agents are generally more successful at selling policies, than maintaining them in force. There is no legal liability for an insured person to continue paying premiums on an insurance policy, and the insurance company has little motivation to devote

4. The distinction between employment and self-employed workers is discussed by Williams (1997), and other aspects of coverage of self-employed and informal sector workers are dealt with in the *International Social Security Review* (ISSA, 1999).

resources to persuading the insured person to pay the premiums; instead it limits its losses on the lapsed policy, by "writing it off".

This approach is not appropriate for a statutory social security scheme. Participants do not have the option of lapsing their mandatory contributions. Contributions have to be collected, and enforcement activities, by the body that is responsible for collecting contributions, must deter evasion. There is little incentive for private fund managers to devote resources to compliance, since evaders are predominately individuals, whose contributions would be small, and generate relatively high transaction costs. A centralised collection agency may pursue a more diligent enforcement policy. No matter how enforcement is undertaken, it is a legitimate, and significant, expense, of a social security scheme.

Collection systems

"In most countries, social insurance contributions for mandatory pension systems are collected by a public agency. Marginal costs are lowest, when collection of contributions can piggy-back onto existing income-tax collection systems. There are good reasons for this. An income-tax collection agency has extensive infrastructure in place, that can not only collect contributions, but also perform important verification, oversight, and enforcement functions" (Heller and Gillingham, 1999, p. 4). Despite the apparent merits of a joint collection system, separate collection systems for social security contributions, and income tax, are maintained in most countries. In countries which have introduced DC individual accounts schemes with private fund managers, contributions are paid directly to the fund managers (*e.g.* Chile, El Salvador, Peru) or to a central collection agency, which transmits them to the fund managers selected by the contributors (*e.g.* Argentina, Mexico, Uruguay).

It was once held that social security contributions, and income tax, should be collected separately, since workers were more disposed to pay social security contributions that conferred rights to identifiable benefits, than to pay income tax; consequently, the two deductions from wages should not be confused. Even with separate collection systems, workers who might be prepared to pay their social security contributions, but were determined to evade income tax, would evade both, if effective arrangements for sharing information between the collection systems were in place.

Social security contributions may be payable from a lower income threshold, than the threshold for income tax. Hence, a joint collection agency might devote less attention to low-paid workers, who are liable to pay social security contributions, but not income tax, thereby abetting low-paid workers' evasion of their social security contributions.

The evident economies of scale, and efficient enforcement, that should be possible with a unified collection system, cannot materialise, unless two critical conditions are met:

- There must be a strong fiscal administration. (In some countries, it is claimed that the social security organisation collects contributions more efficiently, than the tax collection agency collects income taxes.)

- The social security organisation, and the participants in the scheme, must be confident that a joint collection body will act solely as an agent who receives, and transmits, social security contributions to the social security organisation, without delay, or diversion. (Since the joint collection body is, generally, a government body, in countries where governments face chronic budget deficits, this confidence can be difficult to build. Also, the concept of "agency" may be poorly understood in former command economy

countries, where the tax collection authority is unaccustomed to crediting revenues anywhere, other than to the state budget.)

If these conditions are fully met, a social security organisation, which changes to a joint collection system, could expect an improvement in compliance (McGillivray, 1997, p. 62).

With respect to collection systems, it is tempting, but inappropriate, to identify best practice. As Ross (1997, p. 12) states "a basic proposition that may sometimes be lost sight of ... is that 'real circumstances' in any country should determine the nature of the administrative arrangements that are utilised to collect social contributions and taxes". Real circumstances include the size, and characteristics, of the population of the country, the resources available to the government (financial, personnel, information technology), political time frames, and other constraints, and the national cultural, and social, situation. Ross concludes, "Administrative arrangements that do not take adequate account of real circumstances generally fail to operate properly".

While the focus may be on compliance with social security contribution obligations, it must be borne in mind, that participants in a social security scheme are citizens, or residents, of a state, and generally, also taxpayers. For a modern state to function, it is necessary for the polity to respect the statutes and regulations of the state. In the long run, an effective joint social security contributions, and income tax collection agency, can benefit society as a whole.

Conclusion

Compliance of participants with social security contribution conditions, is a subject that has received little attention. The opposite of compliance, evasion of social security contributions, is generally illegal, and social security administrators are sometimes reluctant to admit they face compliance problems. Hence, while the coverage of a social security scheme may be well-defined, the extent to which covered persons are actually participating in the scheme is not, and few statistics are available. But compliance is important. No social security scheme, reformed or not, DB or DC, publicly, or privately managed, funded or PAYG, and no matter how well it may be designed, will achieve its objectives, if participants do not comply with the contribution conditions. Non-compliance creates the risk that covered persons who evade their pension scheme contribution obligations will have inadequate pensions, and that the state will be called upon to remedy the shortfall. The principal causes of evasion, and possible remedies, and alternative contribution collection systems, have been indicated; but the extent of contribution evasion results from national circumstances, and appropriate measures, which promote compliance, depend on appropriate national initiatives, and the allocation of the resources necessary to implement them.

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Table 18.1. Minimum pension provisions in selected countries

	Minimum contribution Period (years)	Amount
Argentina*	30	Discretionary
Chile	20	=25% of average wage
Colombia*	22	One minimum wage = 60% of average wage
Mexico*	25	Mexico City minimum wage = 40% of average wage
Uruguay*	35	Discretionary

* Applies to both public DB scheme and private DC individual accounts schemes.

Source: Queisser (1998), pp. 67-68.

Table 18.2. Ratios of contributors to affiliates in DC individual accounts schemes in Latin America

	EAP covered (in %)	Queisser (1998) Contributors/Affiliates	Mesa-Lago Contributors/ Affiliates (in %) 1997	Mesa-Lago Contributors/ Affiliates (in %) 1998
Argentina	80	49	52	49
Bolivia	–	–	–	–
Chile	98	56	54	56
Colombia	30	67	50-53	
Mexico	33	65	–	65
Peru	32	44	45	
Uruguay	70	Na	72	61

EAP = Economically Active Population (coverage refers to the public and private systems).

Source: Queisser (1998), Table 4.1, p. 56 and Table 5.1, p. 71; Mesa-Lago (1997), p. 420 data for 1996; Mesa-Lago (1998), Table 3, p. 792 new data.

GLOSSARY

AOW	National Pension Scheme (The Netherlands)
BfA	Federal Insurance Institute for Salaried Employees (Germany)
CBOS	Polish Statistical Office
CEE	Central and Eastern Europe
DB	Defined Benefit
DC	Defined Contribution
ECOFIN	Economic and Financial Affairs Council
EFTA	European Free Trade Associationa
EPC	Economic Policy Committee
EMS	European Monetary System
EMU	European Monetary Union
EU	European Union
EUR	Euro
FEP	Bridging Pension Fund (Poland)
FERI	Financial and Economic Research (Germany)
GDP	Gross Domestic Product
HUF	Hungarian Florin
IFIs	International Financial Institutions
ILO	International Labour Organisation
IMF	International Monetary Fund
INPRS	International Network of Pension Regulators and Supervisors
INPS	Istituto Nazionale della Previdenza Sociale (Italy)
ISSA	International Social Security Association (Geneva)
LFMI	Lithuanian Free Market Institute
MLSAF	Ministry of Labour, Social Affairs and the Family (Slovak Republic)
NC SR	National Council Slovak Republic
NDC	Notional Defined Contribution
NSSI	National Social Security Institute (Bulgaria)
OKS	Civic Conservative Party (Slovak Republic)
PAYG	Pay-As-You-Go
PPC	Pension Provision Contract (Germany)
PPF	Private Pension Fund (Latvia)
PTE	Pension Fund Society (Poland)
SEKIF	Registry of Accounts and Funds (Poland)
SIA	Social Insurance Agency (Slovak Republic)
SKK	Slovak Crowns
SPIC	Supplementary Pension Insurance Company (Slovak Republic)
SPS	Supplementary Pension Schemes (Slovak Republic)
TEC	Treaty establishing the European Community
TEU	Treaty establishing the European Union
UNFE	Superintendency of Pension Funds (Poland)

USAID	United States Agency for International Development
USD	United States Dollars
ZPIZ	Pension and Invalidity Insurance Institute (Slovenia)
ZUS	Social Security Institute (Poland)

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PRINTED IN FRANCE
(14 2004 01 1 P) ISBN 92-64-10580-8 – No. 53335 2004