


# PENSION REFORM IN EMERGING EUROPE: THE UNCERTAIN ROAD AHEAD

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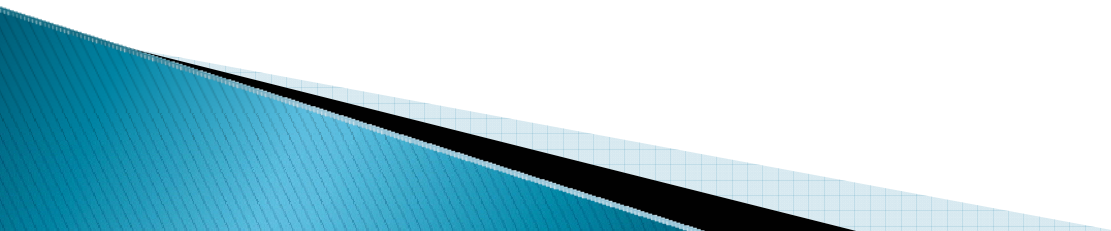
# I. Motivation

Several CEE countries have reduced pre-funding of future liabilities since 2009:

- Lithuania, Latvia, Romania, and Estonia: temporary measures and fiscal consolidation during crisis.
- Hungary : eliminated the private pillar pension system at end-2010, taking over assets, with expansionary fiscal measures.
- Poland: permanent reduction in contributions as of May 2011, with other consolidation measures.

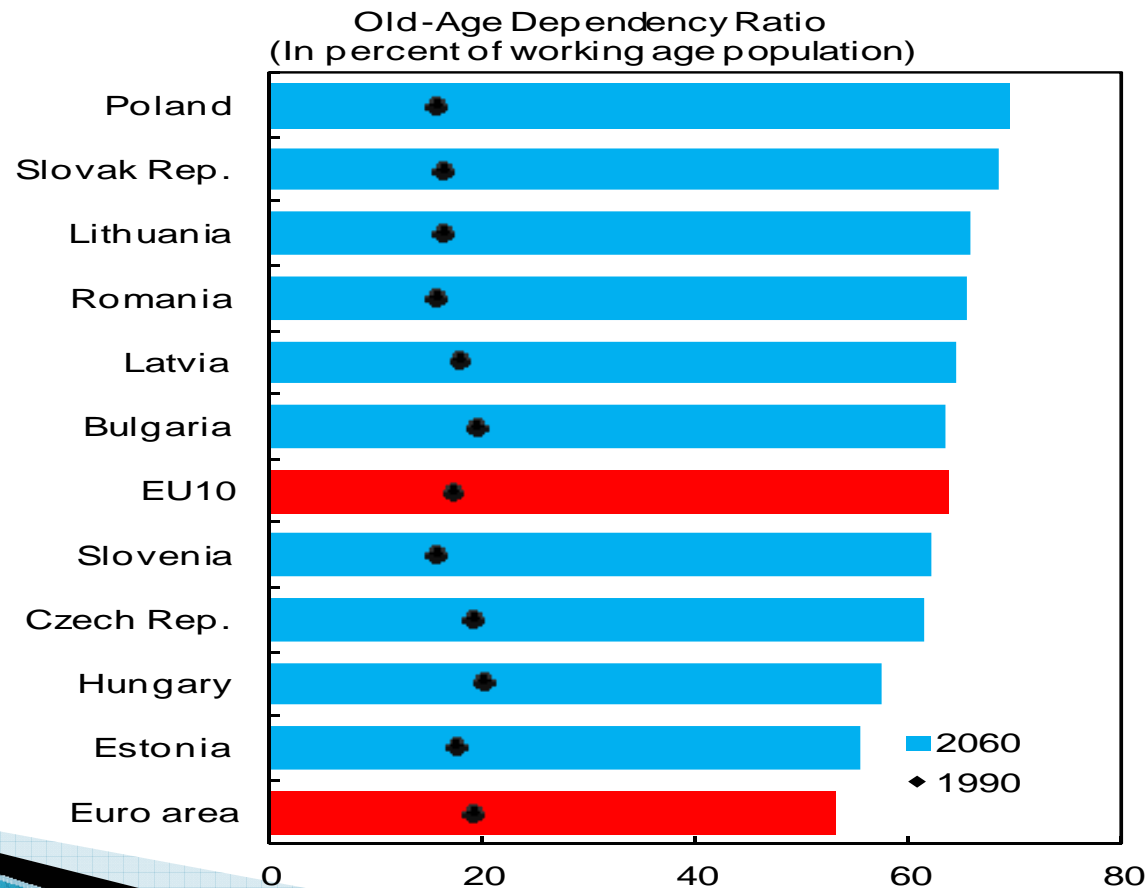
# II. Objective

## ▶ This paper aims to:

- take stock of the pension reforms undertaken in the CEE, including on long-run fiscal sustainability ;
  - analyze the fiscal implications of pre-funding of pension liabilities (Poland as a case study);
  - discuss the increasing tension between pre-funding pension liabilities and SGP rules in the context of the recent reform reversals;
  - conclude with some policy implications.
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# III. A Retrospective on Eastern Europe's Pension Reforms

Population aging has been looming over CEE:



# Existing pension systems were unsustainable:

(in percent of GDP)

Country	Public debt	Pension Spending	Implicit Pension Debt
Slovenia	25	11	298
Poland	43	12	261
Romania	18	6	256
Slovakia	31	8	210
Hungary	59	9	203
Croatia	33	11	201
Estonia	7	9	189
Lithuania	28	7	15

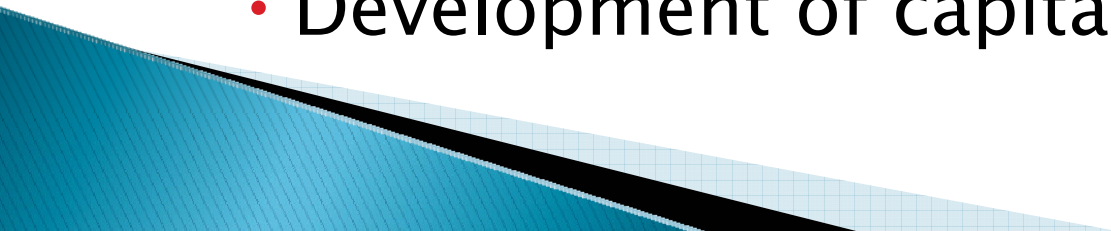
Source: Holzmann, Palacios, and Zvinienė (2004)

# As a result, CEE countries adopted multi-pillar pension systems including a private, (in most cases) mandatory, pre-funded DC pillar II

	Hungary	Poland	Latvia	Bulgaria	Estonia	Lithuania	Slovakia	Romania
Pension reform date	1998	1999	2001	2002	2002	2004	2005	2008
	DB, PAYG	NDC, PAYG	NDC, PAYG	Pension points	DB, PAYG	DB, PAYG	Pension points	Pension points
<b>Public pillar I</b>	Prefunded	Prefunded	Prefunded	Prefunded	Prefunded	Prefunded	Prefunded	Prefunded
<b>Private pillar II</b>								
Mandatory/optional	Mandatory	Mandatory up	Mandatory up	Mandatory up	Mandatory up	Optional	Mandatory	Mandatory up
	for new	to age 29,	to age 29,	to age 42	to age 18,		for new	to age 35,
	entrants	optional ages	optional ages		optional for		entrants	optional ages
		30-49	30-49		others			35-44
Individual	8	7.3	to increase to	to increase to	2 (employer's	5	9 employers'	to increase to 6
Contribution Rate			10	5 (incl.	contribution		contribution	
Contributors as	69	95	82	77	80	52	72	N/A
share of employed								
Assets in percent of	6.3	11.1	3.9	1.8	3.6	4.0	1.7	N/A
GDP, end-2006								

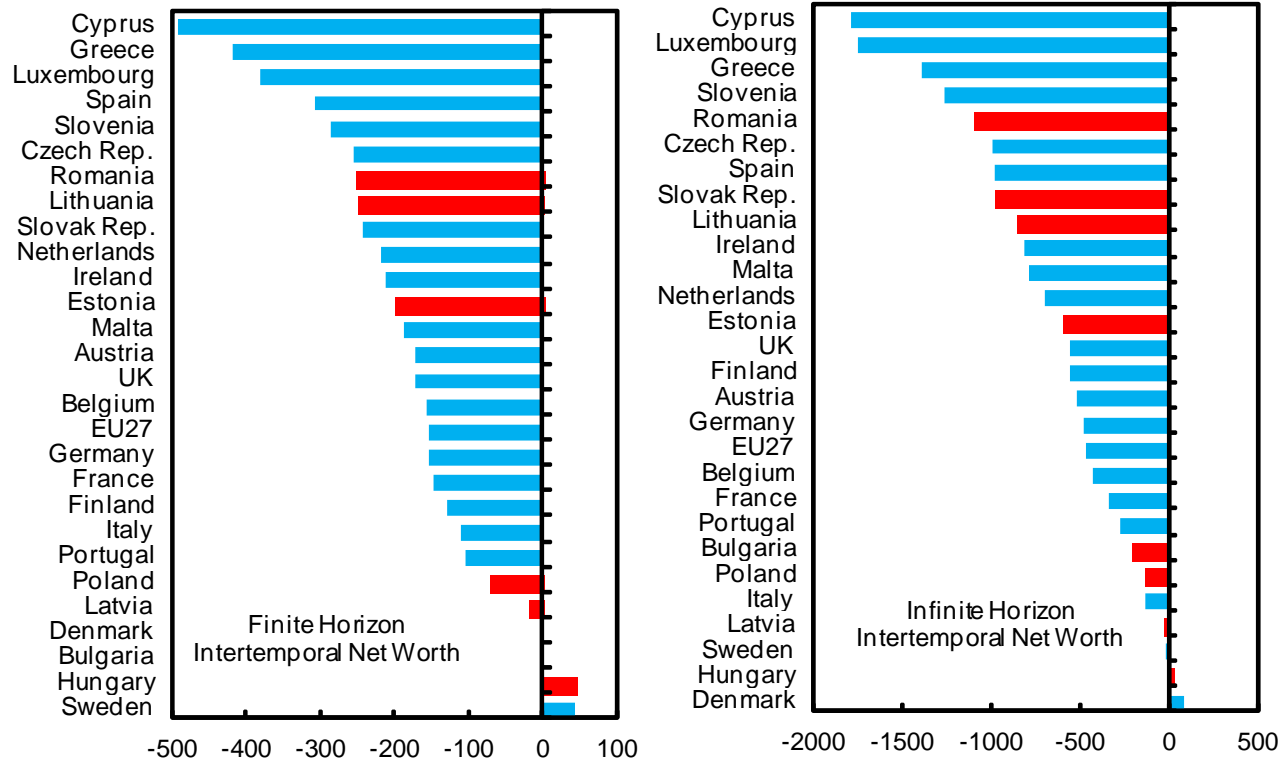
Source: Muller (2008)

# The reforms were expected to have many benefits:

- Improvement in LR sustainability;
  - Increased labor participation;
  - Better risk diversification;
  - Higher private and national saving;
  - Development of capital markets.
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# Ex post, CEE fiscal sustainability positions have improved.

EU27 Intertemporal Net Worth Derived from the Balance Sheet Approach  
(In percent of GDP)



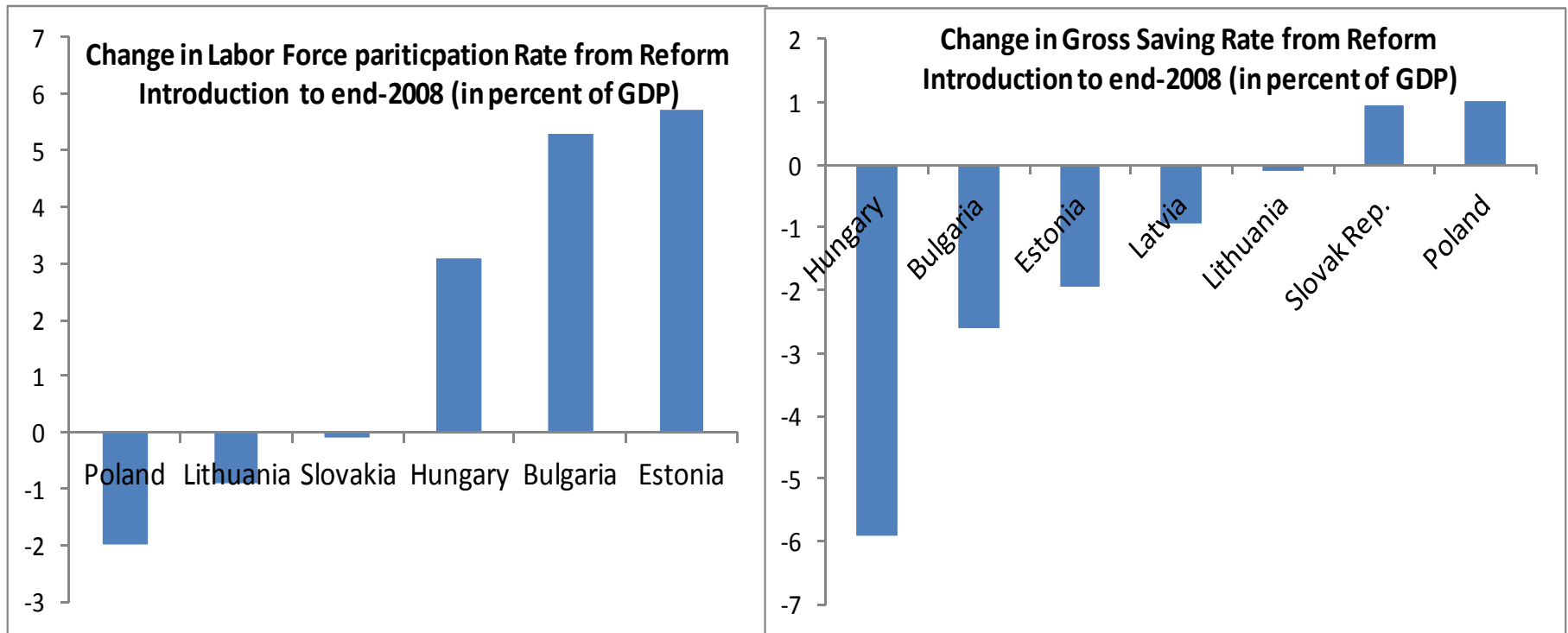
# ...in large part because of reforms of the pillar I that reduced aging costs:

Select CEE Countries: Contributions to Finite-Horizon Intertemporal Net Worth  
(In percent of GDP)

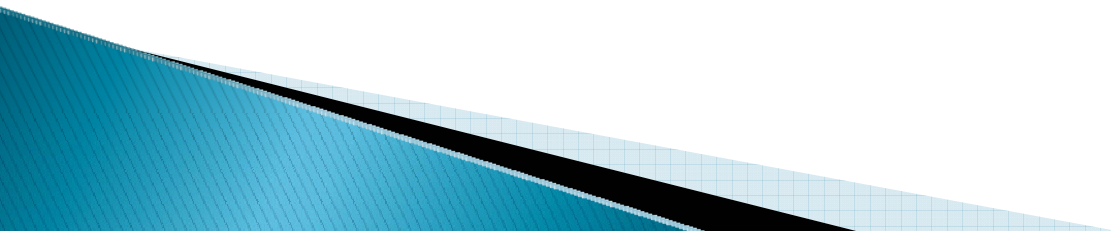
	Finite-Horizon Intertemporal Net Worth	Current Net Worth Contribution	MT Primary Adjustment Contribution	LT Aging Costs Contribution
Hungary	43	-59	153	-51
Bulgaria	0	8	54	-62
Latvia	-20	-7	38	-50
Poland	-72	-22	-44	-5
Estonia	-200	29	-226	-3
Slovak Rep.	-243	-1	-109	-133
Lithuania	-250	0	-156	-94
Romania	-252	-11	-51	-190
Euro Area avg.	-233	-33	-57	-143

Source: Velculescu (2010), and IMF staff estimates. Data from Spring 2010 IMF WEO

# But other benefits have yet to materialize:



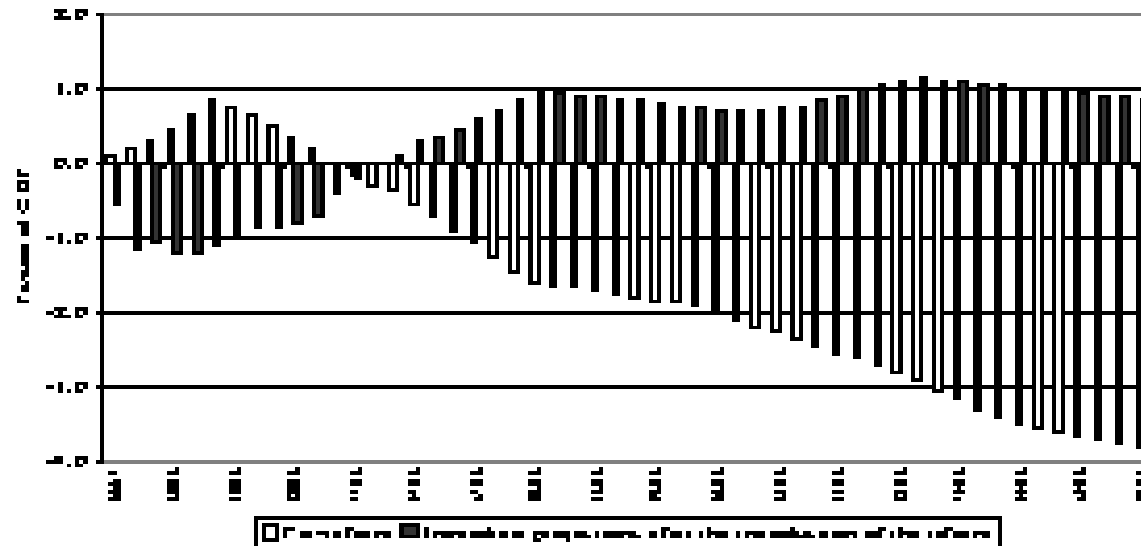
# The cross-country international evidence is mixed. Why?

1. **We should not expect any benefits. But case-studies (Chile) show large positive effects, and some evidence on capital market effects.**
  2. **Benefits hindered by other reasons:**
    - recent reform track record;
    - limited size of the pillar II;
    - Debt financing of transition costs;
    - Regulatory aspects in pillar II.
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# IV. Fiscal Costs of pre-Funding of Pension Liabilities

Initially, costs were expected to be significant but manageable.

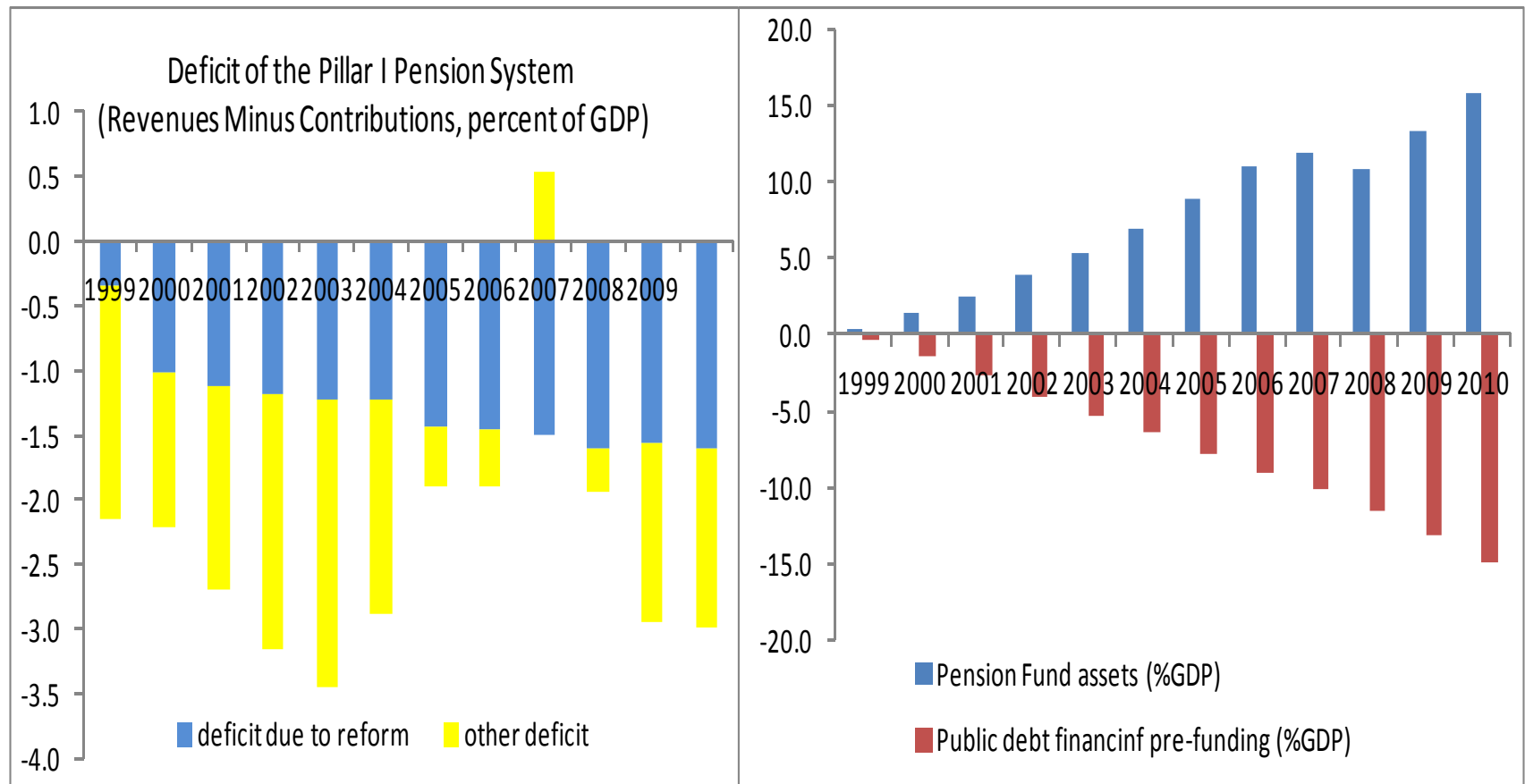
Figure 11. Rebased: The Fiscal Impact of the 1999 Pension Reform  
(The balance of the state-managed part of the pension system relative to GDP)



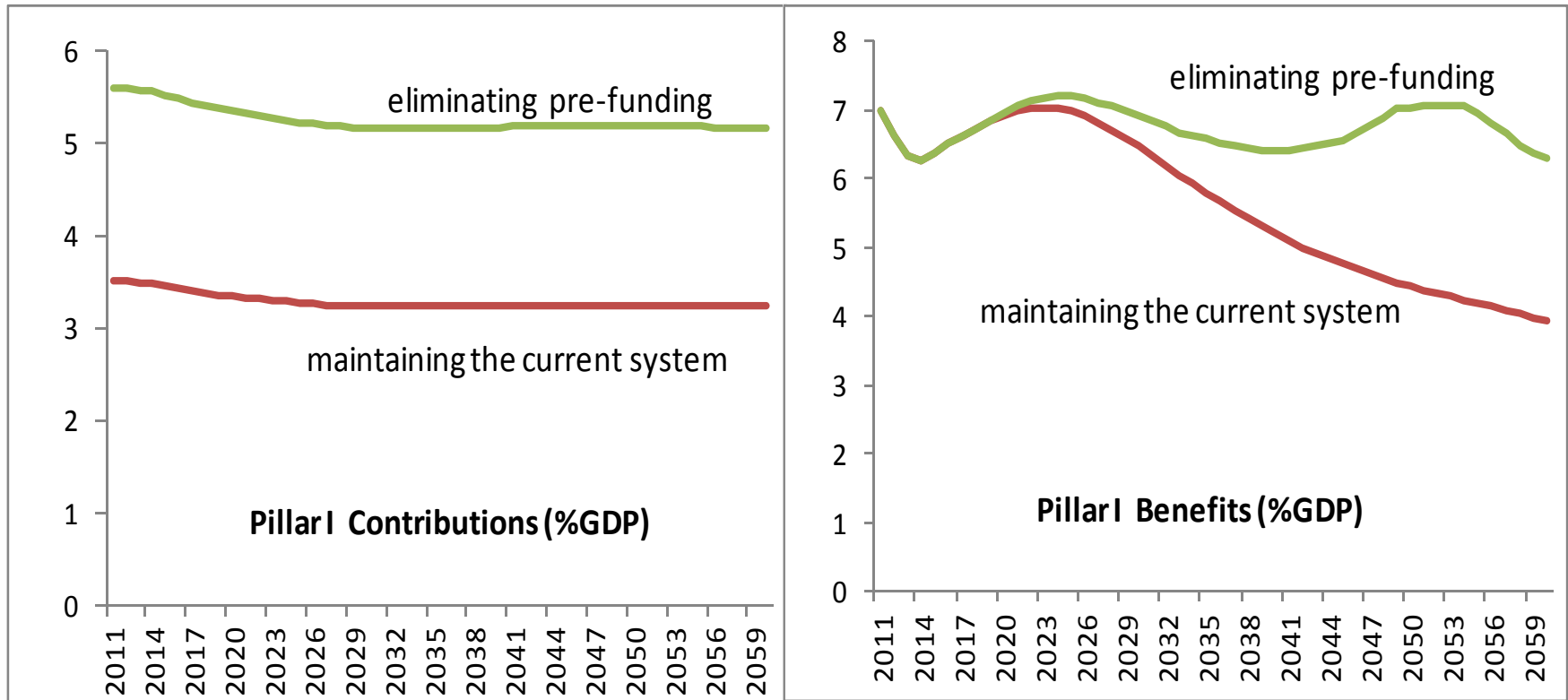
Source: Chikun, Góra, and Rutkowski (1999).

# Ex post, costs turned out larger and long-lasting.

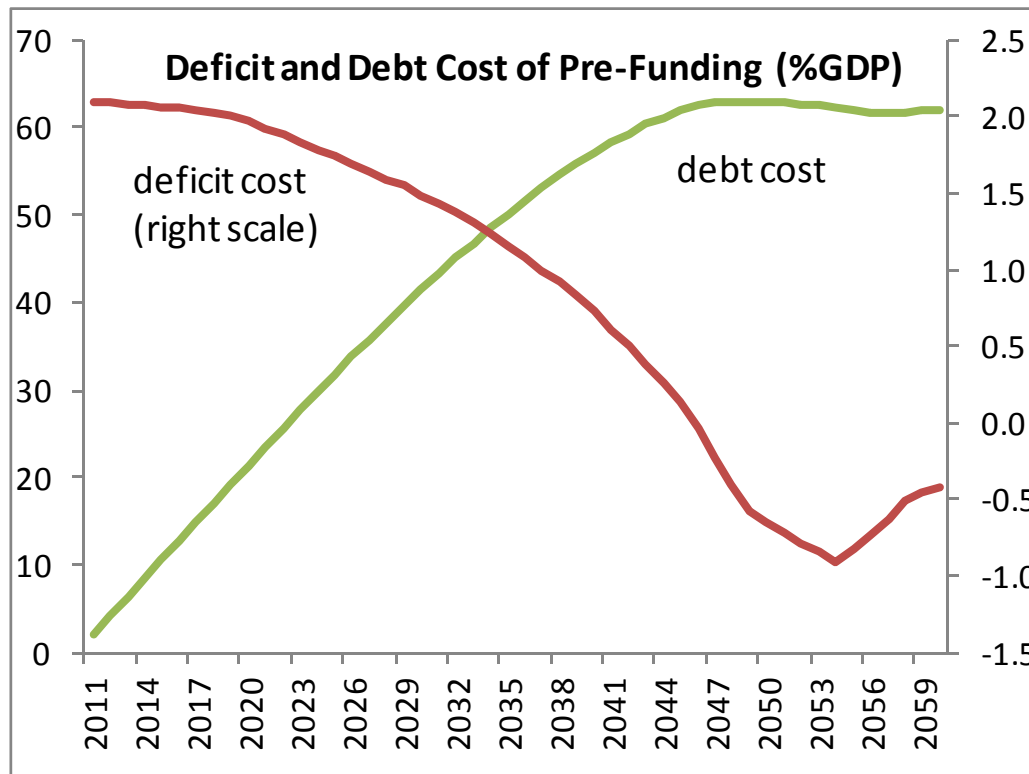
## Poland: Deficit and Debt due to Pre-Funding



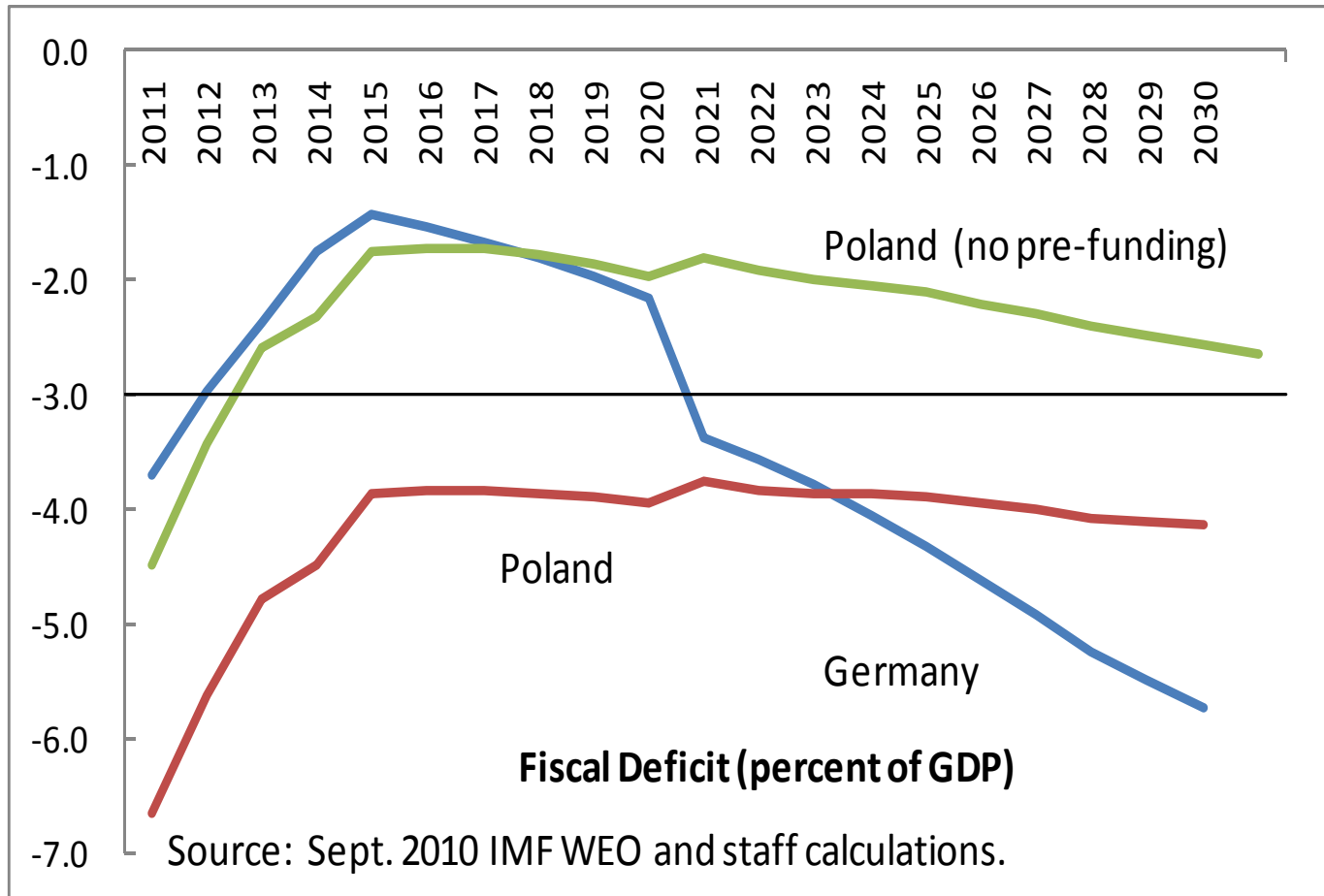
# Looking forward, debt-financed pre-funding is expected to further add to fiscal costs.



# In Poland, estimated costs are significant and persistent.



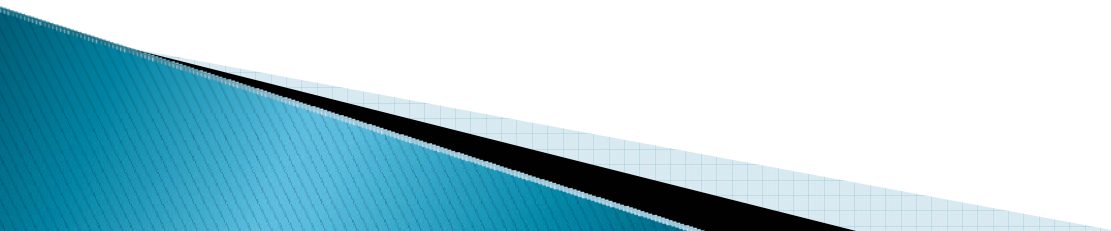
# V. Pension Reforms and SGP Rules on a Collision Course



# The issue was recognized before, with SGP rules modified to allow for:

- ▶ More flexibility in defining MTOs to take into account long-run aging costs;
- ▶ Regressive deductions of net reform costs from debt and deficit levels, over a limited period of 5 years.

## But past temporary fixes were not sufficient:

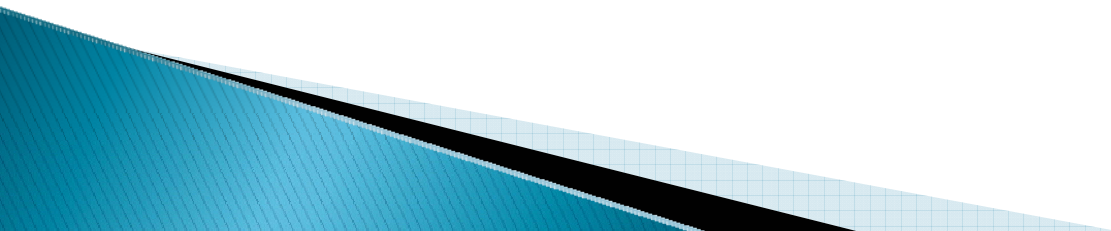
- Maastricht debt and deficit limits applied uniformly;
  - MTOs are not closely aligned with aging costs and not binding.
  - New strengthened rules would “punish” reformers once in the Euro area.
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# Recent reform reversals testimony that temporary fixes have not worked.

## Recent Measures Affecting the Private Pillar II Pension System

Hungary	Diverted contributions to pillar I and made pillar II system voluntary. Provided incentives for contributors to switch accumulated assets to the first pillar.
Poland	Plans to implement a reduction in contributions to 2.5 percent starting in April 2011, to be gradually raised to 3.8 percent by 2017.
Latvia	Reduced contribution rates to 2 percent temporarily.
Bulgaria	N/A
Estonia	Suspended contribution rates temporarily.
Lithuania	Reduced contribution rates to 2 percent temporarily.
Slovakia	N/A
Romania	Froze contribution rates to pillar II at 2%.

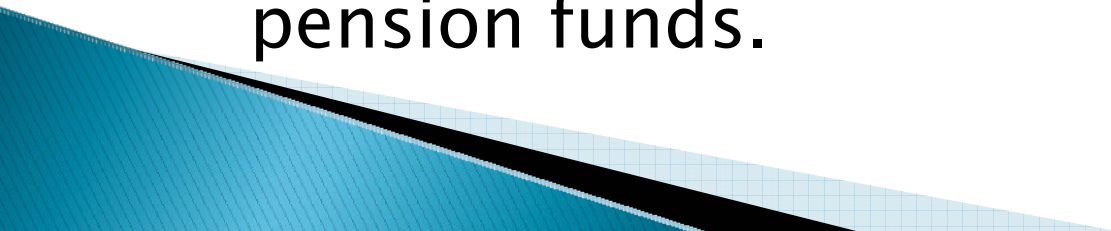
## Assessment:

- ▶ Temporary measures: pragmatic crisis solution, but issues on intertemporal cost sharing;
  - ▶ Permanent changes could be risky: if they postpone fiscal adjustment (or encourage extra spending) and weaken credibility.
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# VI. What is the Way Forward?


## 1. Individual country policies:

Preserve private pension systems, supporting them with policies limiting costs and enhancing benefits:

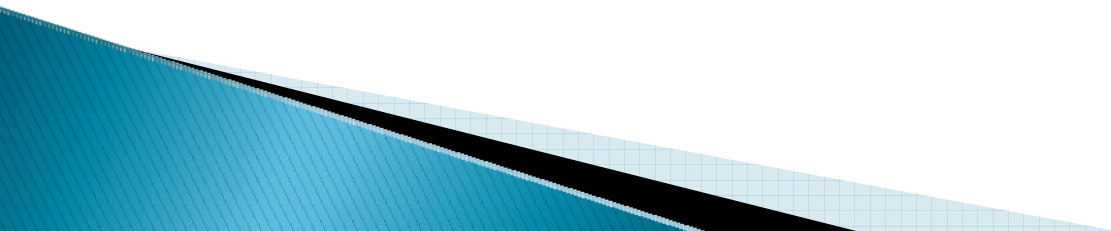
- ▶ Pre-funding through fiscal consolidation and debt, depending on available fiscal space.
  - ▶ Improve regulation and supervision of pension funds.
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## 2. Policies at the EU level:

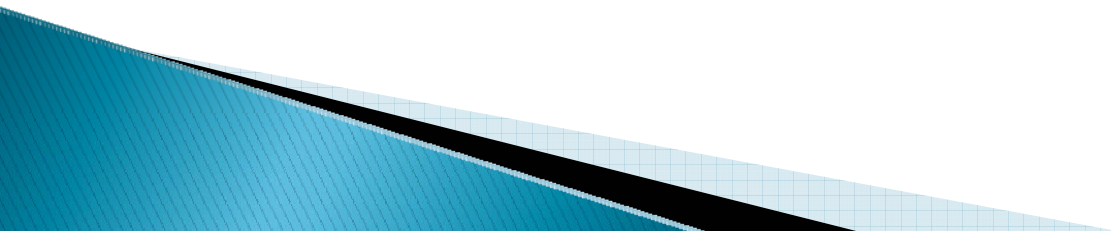
Place more emphasis on forward-looking indicators:

1. Current limits focus exclusively on backward looking indicators of deficits and debt.
    - Myopic, incomplete picture.
    - Modifying these to exclude pension costs is straightforward, but further limits transparency.
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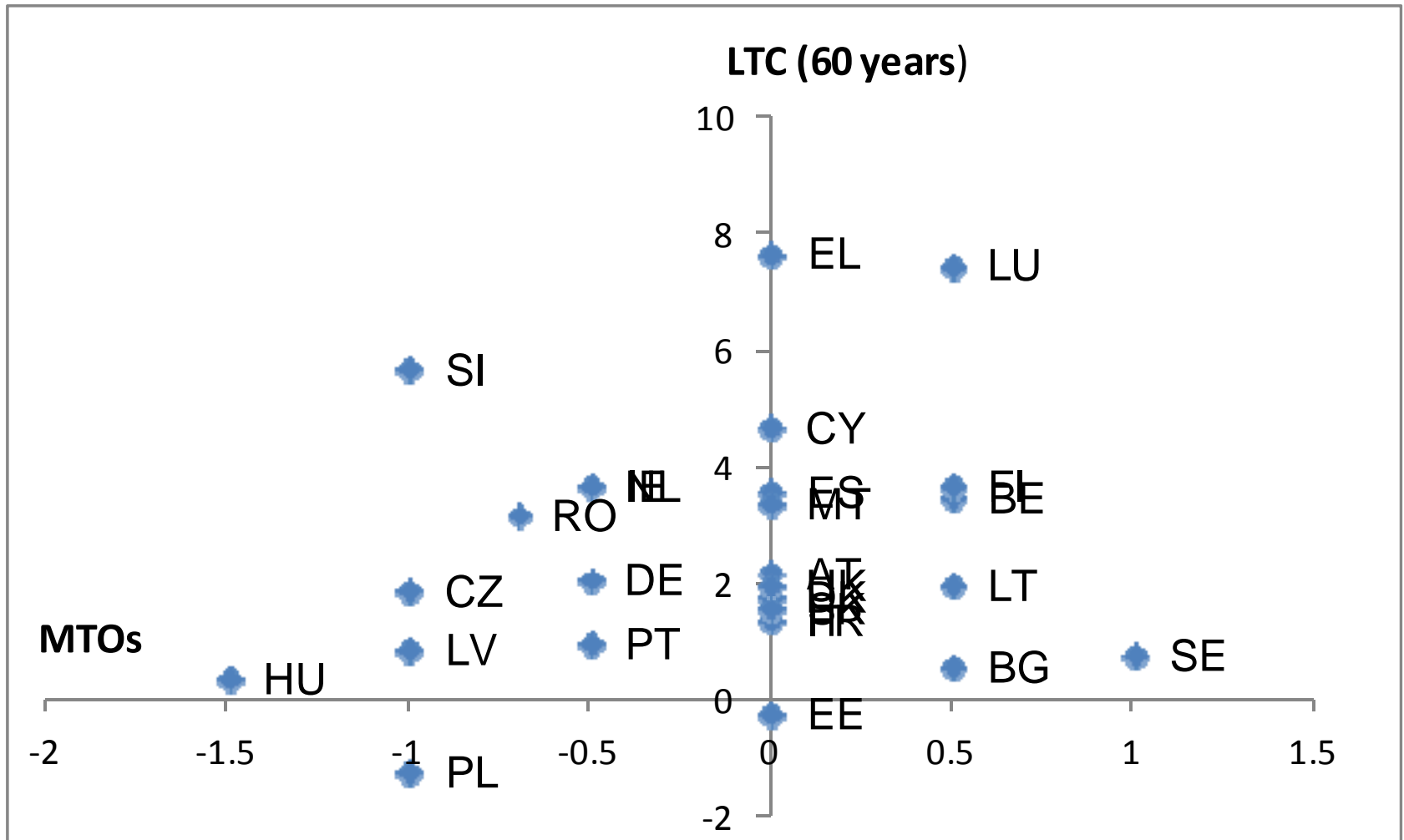
## 2. Need to complement with forward-looking indicators:

- $S1$ ,  $S2$ , measures of intertemporal net worth;
  - More complete, transparent picture;
  - Theoretically grounded;
  - However, more complex to compute.
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# How to operationalize? Some thoughts:

- ▶ Build on the existing framework:
    - Maintain the Maastricht deficit and debt limits as triggers for entry into and exit from the EDP;
    - Keep MTOs country specific but align them more closely with long-term fiscal indicators (S1 and S2, or sub-components, such as LTC);
    - When in EDP, base CPs on plans to attain the strengthened MTOs.
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# LTCs and MTOs are currently not aligned:



## ▶ Additional considerations:

- Need to establish a clear and common methodology to calculate aging-costs
- Create independent body to perform these calculations
- Update calculations of forward-looking indicators on a more frequent basis.

**Thank You!**

