

Sustainable, safe and adequate pensions in the ageing society. Policy dilemmas.

Introduction. The paper presents personal experiences and views of the author related to some of the aspects of the pension reform's debate and reform's process in Poland and also in some other countries of Central and Eastern Europe. The paper is not aimed at present a detailed overview of the reforms nor to give a full account of the political processes behind them, as it was already done in a number of publications.¹

The tradition of the European welfare state policies is strongly linked to the notion of "adequacy" of benefits and to setting relevant standards defining what is adequate. The standards in questions are those of the International Labour Organisation (in case of pensions these are standards set by ILO Conventions 102 and 128) and of the Council of Europe, accepted also by most of the European Union member countries (the European Social Charter and the European Code of Social Security). It should be also stressed that both ILO social security conventions and Council of Europe's Code treat the question of ensuring adequate, sustainable and fair financing of benefits promised as equally important as adequacy of benefit coverage, levels and entitlements. European Union's open method of coordination follows these principles and also uses the notion of "adequacy" of pension benefits as one of the three main objectives, together with "safety" and "sustainability", which a desired national pension system should meet.²

¹ See for example: Pension Reform in Central and Eastern Europe, vol. 1 and 2, collection of papers by various authors edited by E. Fultz, ILO Budapest, 2002; K. Müller, The political economy of pension reform in Central-Eastern Europe, Edward Elgar, 1999; Joan M. Nelson, The politics of pension and health care delivery reforms in Hungary and Poland, Collegium Budapest Discussion Paper, mimeo, 1998; E. Fultz, Pension Reform in the EU Accession Countries: Challenges, Achievements and Pitfalls, International Social Security Review, Vol. 57: Issue 2, April 2004, pp. 3-24; E. Fultz and M. Ruck, Pension Reform in Central and Eastern Europe: An Update on the Restructuring of National Pension Schemes in Selected Countries, ILO, Budapest, 2000; K. Hagemeyer, The Transformation of Social Security in Central and Eastern Europe, in: K. Müller, A. Ryll, H-J. Wagener: Transformation of Social Security: Pensions in Central-Eastern Europe, Physica-Verlag, Heidelberg-New York 1999; M. Cichon, K. Hagemeyer and M. Ruck, Social Protection and Pension Systems in Central and Eastern Europe, ILO, Budapest 1998,

² See for example: Commission of the European Communities, Communications from the Commission to the Council, to the European Parliament and to the Economic and Social Committee: "The Future Evolution of Social Protection from a Long-Term Point of View: Safe and Sustainable Pensions", Brussels, 2000; "Supporting national strategies for safe and sustainable pensions through an integrated approach", Brussels 2001, "Quality and viability of pensions – Joint report on objectives and working methods in the area of pensions", Brussels 2001 and "Joint report by the Commission and the Council on Adequate and Sustainable pensions", Brussels, 2002.

The pension reforms in Poland and some other countries of Central and Eastern Europe debated and legislated over the last decade were following quite a different agenda, with “adequacy” practically disappearing from the main objectives of the pension policies. The reform agenda actually followed³ can be summarised into the three main objectives:

- a. Limit the growth of publicly financed pension expenditure in the long-run
- b. Increase the role of pre-funding in financing of old-age pensions
- c. Increase the role of private sector in old-age pension provisions

These objectives, through lowering size and scope of public pension guarantees, were also treated as a way to cope with the so-called “old-age crisis”, but they should be also seen as part of a wider agenda aimed at a smaller state and smaller public spending, at a narrower scope for public intervention and redistribution and a bigger role for private sector and markets.

To achieve these objectives, it is usually recommended to introduce mandatory, privately managed pension arrangements of a significant size (a so-called “second pillar”). This is supposed to help in achieving all three objectives.⁴ Additionally, whatever is left from the existing “pre-reform” pension schemes financed on a PAYG basis (the so-called “first pillar”) is to be trimmed down by “parametric” reforms consisting of reduced replacement rates, tightened eligibility conditions, increased retirement ages and reduced indexation provisions. Voluntary pension provisions for those with higher incomes are additionally recommended to form the so-called “third pillar”.

The ideal three pillar pension system would be such, where the first, public and PAYG financed “pillar” is purely earnings/contribution related, with any redistribution limited to a minimum – so that eligibility conditions are tight and incentives to contribute longer and retire later are strong. That is why the generic “model” of a first pillar is a notional defined contribution (NDC) old-age pension scheme.

There should be a minimum pension guarantee for pensions paid by the mandatory part of the system but only for those who contributed for a high minimum period of – for example - 20 to 25 years. Otherwise – for those with shorter contribution spells – old-age security is to be provided out of own private savings or, if not available or exploited, by means-tested social assistance.

³ See for example: Pension Reform in Europe: Process and Progress. Edited by R. Holzmann, M. Orenstein, and M. Rutkowski, World Bank, Washington 2003.

⁴ Objective (a) is achieved indirectly through effective lowering of the replacement rates.

Polish pension reform can be treated as the one the closest to the “ideal” model: all the pillars are the defined contribution ones. However, it may be difficult to make such a system compatible with social policy strategies that put adequacy and sustainability of pensions at an equal footing when formulating policy objectives. Why then the reform happened in such a shape?

Why was it so successful? Poland - and other countries in transition from centrally planned to market economies - were a perfect testing field for the reform agenda described above. In those countries public social security pensions were practically the only source of old age income, with no room for supplementary provisions for those with higher incomes. The pension systems were usually very redistributive, providing low replacement rates for those with high earnings. There was, thus, strong support from middle and high-income earners for a change towards more earnings/contribution related pensions. Additionally, the countries were going through large-scale liberalizations and privatisations of their economies and, thus, at least partial privatisation of their pension schemes seemed - for many architects of the transitions - a logical element of the economic reforms. Governance failures of the public social security schemes (and of many public institutions in general) have strengthened support for privatisation. Later, the countries started to experience also the negative consequences of lax ("liberal") regulations of their private sectors, financial and capital markets, of the low standards of business ethics and corporate governance in the emerging private sectors but long and bad past experience with public provisions keeps the belief in effectiveness of private ones alive and still strong.

The natural ally of such pension reform agenda was - and is - the financial services sector: banks, insurance companies and other institutions expecting to profit from the privately managed fully funded pension systems (and particularly from the mandatory ones). The financial services sector was the most underdeveloped part of the transition economies at the beginning of the 1990s but the most rapidly growing since then. Also, in most of the transition countries in question, the share within this sector, owned by big international banks and insurance companies, was growing even more quickly (and still is). It is, thus, not accidental that everywhere representatives of that sector were the most active group lobbying in favour of the pension reform resulting in a significant share of advanced funding and in privatisation of pension provisions. Mandatory participation in the private pension funds is certainly one of the most gourmand parts of such a reform for

the financial sector services. During the reform debates in Poland, Hungary and other countries one could see numerous seminars and conferences organised and sponsored by domestic and international financial companies to bring together the World Bank experts presenting its pension agenda⁵. The sector was also lobbying actively in the Parliaments when the reform bills were discussed there. Effectiveness of this lobbying seemed to be however positively correlated to the way the financial sectors performed in the countries: Lobbying was much less effective in the Czech Republic, which went through a number of financial and capital market affairs resulting from bad governance and lack of transparency in the regulatory framework, and much more effective in Hungary and Poland, both hailed for their relatively much higher governance and transparency standards in their respective regulations of financial services and capital markets.

Pension reforms in Poland, as well as in Hungary, Croatia, Baltic republics, Bulgaria etc. were not imposed by the World Bank. World Bank brought in the convenient intellectual blueprint. There were quite strong internal forces pushing for such a reform. The external pressures were coming rather from a wider context of international financial and international capital markets. It was reflected in the fact that international rating agencies regarded pension reforms following the World Bank's blueprint as a sign of responsible financial governance. Many countries in the region had significant external debt; all of them needed desperately foreign investments, as huge external financing was necessary to reconstruct and restructure their economies, helping, also, to stabilize their exchange rates. The needs for external funds were comparable in size with what Western Europe got within the "Marshall Plan" after the World War II. But this time these funds had to come rather in a form of private direct investments than international public assistance. This made the countries' prospects very dependent on how they were rated internationally.

However, at the beginning, IMF was rather reluctant to accept pension reform introducing a fully funded pillar as an evidence of "responsible fiscal governance". The reason was in unavoidable and significant costs of transition (even partial) from PAYG financing to fully funding. These reforms widen a gap in financing pensions currently in payment, which has to be financed either from increased taxation or increased public borrowing. Taking into account already significant public deficits in most of the countries

⁵ This experience is not limited to Central and Eastern Europe. The most spectacular example was the European Pension Congress organised by the World Bank in Munich in 2002 to promote its reform agenda in the European Union countries, which was fully financed by international insurance and financial services companies.

in question, explains IMF's lack of enthusiasm. Evidence of this IMF's position towards pension reforms can be found for example in the paper published in 1993⁶. Authors conclude: "As regards more systemic reforms, a public two-tier pension system, with a flat-rate minimum pension as the first tier and a defined-benefit second tier, none of it covered by a budget guarantee, would probably serve the country best. More radical, Chilean-type reforms should not be considered because they have strong budgetary implications, particularly in the short to medium term, and could easily increase macroeconomic imbalances." Later the IMF's attitude became more favourable to the pension reforms introducing pre-funding of defined contribution benefits but only on the condition that the transition cost will be accommodated to a largest possible extent by cuts in spending on currently paid pensions as well as in other social protection expenditure.

Leading analysts the "political economy" of pension reforms stress thus the role of outside forces in the reform process, pointing out that more heavily externally indebted countries were more prone to follow the World Bank reform's blueprint, while reformers in less indebted countries (like Czech Republic and Slovenia) were more immune to the "new pension paradigm".⁷ However, while these leading analysts of see external actors playing the main role in shaping the overall directions of the reform, they both agree that it were local actors who decided the reform design's details.

The question is, who where these local actors. For, sure, the Ministries of Finance and neo-liberally minded experts played an important role, especially through preparing the analytical ground for the reforms. But these reforms could not have been pushed through just from a group of ministerial bureaucrats and economists without wider and stronger support from other parts of the society. The actual reforms went along the proposed reform agenda only because there was an active support from those quarters of the society, which would be the potential winners in the reform process. Two important groups, actively pushing pension reforms into certain directions, can be identified. The first group is the emerging upper middle-class, well educated, earning more than average and with aspirations and good prospects to have their income increasing in the future. They were the biggest losers in the pre-reform highly redistributive schemes and, not surprisingly, opted for a purely earnings related pension system. Also, they had an interest in limiting their mandatory contributions, thus provided with as much scope as possible for individual

⁶ X. Maret and G. Schwartz, Poland: The Social Safety Net During the Transition, IMF Working Paper No. 93/42, Washington 1993

⁷ See J. M. Nelson, op.cit, pp. 7 and 25 and K. Müller, op.cit. p.54.

choice on how much – and under which institutional arrangement - to save for retirement. This group is, thus, not necessarily in favour of a mandatory fully funded pillar, but the illusion (insinuated with the help of the technical experts, mentioned above) of competition and individual choice (the unquestioned new slogans of socio-economic progress) coming automatically along with privately managed pension funds even within a mandatory savings system made it attractive enough to gain middle class support. This group becomes better and better organised and different liberal parties played a role in promoting radical pension reforms. This group is also very well represented by the media, which – across the whole region – were exceptionally busy in undermining confidence in public social security systems, announcing their “bankruptcy” and advertising individual savings as a solution to the problem of ageing and old-age income security.

The second, even better organised group with strong vested interest in pension reforms according to the World Bank’s blueprint is the financial services industry, dynamically growing and linked to big international companies acting worldwide on financial markets.

Analysts quoted earlier do not pay much attention to the role of the first group (middle class), they notice however some role of the second, although they rather underestimate its actual impact listing it as “secondary” actor. Indeed, this group may not often have been visible in the open debate but it was – and still is - very active behind the scenes. Analysts of the pension reforms seem to underestimate its role. K. Müller lists “local financial institutions” as rather minor secondary “actors”⁸. In Hungarian case she sees only the role Voluntary Mutual Benefits Funds (administering voluntary pension schemes instituted well before the idea of mandatory funded pillar started to be seriously debated). Their major interest was to at least protect their already established position, at the beginning thus they were not very enthusiastic about the proposed mandatory scheme fearing they would lose clients⁹. She somehow overlooks the role of insurance companies and banks, most of them already with large share in hands of the foreign and international financial corporations, who looked forward to enter a much bigger and much more attractive market of mandatory pensions than that of the voluntary ones. J. Nelson notes however the role private insurance played in the Polish debate: “In Poland, a small group representing the association of insurance companies met a number of times with Jerzy Hausner [at that time Government Plenipotentiary for the Pension Reform, KH]. Their goals were to encourage reforms based on capitalization, that is, on fully funded define

⁸ K. Müller, op.cit. p.54

⁹ K. Müller, op.cit. p. 82

contributions rather than pay-as-you-go; to press for broad access to private insurance firms (including foreign firms) to second-pillar programmes; and to promote tax treatment for third pillar firms (managing private voluntary pension funds) equal treatment given to second pillar. The group was disappointed with respect to several features of the semi-final design, and indeed reopened certain questions with the new government after September 1997 elections.”¹⁰ but one may find more evidence of lobbying by the financial sector in the press and particularly in the minutes of the parliamentary commissions where many representatives of the financial services sector were invited as experts.

In Poland there is still (November 2005) one basic law missing to complete the reform package. Although all employed contribute already since 1999 to the funded pillar (and the older among them were free to choose between contributing to a funded pillar or a first PAYG one) they still do not know whether future pensions funded from their contributions will be indexed and, if so, how; whether women and men will be treated equally – that is unisex life-tables will be used to calculate price of the annuity - or not; who (which institution) will pay their pensions; what administrative costs and charges will be associated with the payments; and how the offered options of payment will impact the pension levels (available options include buying an annuity (a) from specially licensed insurance companies, (b) from existing pension fund managers or (c) having it provided by a single public institution). All options would have very different impacts on future pension levels. It is thus rather astonishing that there has been practically no public discussion on these issues and the only actors who actively try to animate the debate and push for certain specific solutions are the pension funds and the life insurance sector. Policy makers, so it seems, think there is still enough time for discussion, as first pensions will be paid under the new system only in 2010.

Interests of those who are the losers of the addressed reforms –those with lower earnings, with incomplete working careers - were only weakly represented in the reform debate. Why?

First, the information on some of the social consequences of reform was scarce. In Poland, reform’s supporters often avoided to show the full picture of consequences. For example, presentations of future benefit levels were usually based on the assumption of

¹⁰ J. Nelson, op.cit., p. 15

both long contributing periods *and* high rates of return, showing the results to be expected by the "happy few".¹¹

Second, trade unions had, as K. Müller¹² points out, very heterogeneous interests. They had a strong focus on defending the interests of current pensioners, who formed one of the largest groups among their membership. In this respect, it helped them that reform proposals were never directly affecting accrued rights of those already pensioners or close to retirement.¹³ They also represented contributors but rather those relatively less affected by the reform, those with longer uninterrupted working careers, rather than those employed temporarily and being often out of employment. Some of the unions (like NSZZ “Solidarność”) actually supported the idea that a new pension system should be at least partially based on pre-funding and even developed own proposals of a new multi-pillar system. The trade union members hoped to profit from the envisaged new system by planning to establish their own pension funds in cooperation with insurance companies (like, again, “Solidarnosc” in Poland, which started a pension fund in a joint venture with the Swiss insurer “Zürich”, or like other Polish trade union confederations).

Third, those supposed to represent potential losers in the debate (like the trade unions) often had no intellectual capacity to develop their own simulations and projections in order to assess the real impacts of the reform or to formulate their own policy proposals.

However, the general societal mood at the time of the reform debates was certainly much more in favour of the winners than of the losers. Interests of the latter were also rather poorly represented at the political scene.

Expected outcomes of the reformed pension system. The new pension systems will reduce replacement rates significantly. It is true that the pre-reform pension system in Poland was relatively generous as compared to other countries in the region and pension spending was high. OECD projections show that – if the current “post-reform” pension legislation stayed unchanged – in 2050 old-age pension expenditure in Poland will consume only 8.3% of GDP compared with 10.8% now. For Hungary the same projections show a slight increase of old-age pension spending: from 6% of GDP in 2000 to 7.2% in 2050¹⁴. The current and prospective demographic situation in both countries is

¹¹ See for example: Office of the Government Plenipotentiary for Social Security Reform, *Security through Diversity: Reform of the Pension System in Poland*, Warsaw 1997.

¹² Op.cit. p.173.

¹³ Although, as one could expect, at least part of the transition costs to the funded system, are being covered through various cuts in current pension spending and thus pensioners are actually paying costs of the reform.

¹⁴ Dang, Thai Than, Pablo Antolin and Howard Oxley, 2001, “Fiscal Implications of Ageing: Projections of Age-Related Spending”, Economics Department Working Paper No. 305, OECD, Paris, table A7, p. 49. Polish

similar; the demographic dependency ratios will double until 2050. The spending differences between the two countries reflect that the Hungarian pre-reform system was less generous than the Polish, the foreseen reductions in replacement rates will, however, be smaller than in the Polish case.

Expected future replacement rates for the new Polish pension system are low¹⁵. The combined effects of a very low rate of return legislated for the NDC part of the system (which was set at 75% of the real wage sum growth, that is usually much lower than growth of real wage per employee) and the effects of the expected increase in life expectancies pulling down the annuity factors used in both pillars, push down the total replacement rates even if rates of return in the second, fully funded tier would be relatively high. Of course, the fall in replacement rates might be reduced if the actual length of employment periods and the actual retirement ages increase significantly.

Another dimension of the reform adds much greater uncertainty with respect to replacement levels. A report by the Polish Pension Fund Supervision¹⁶ provides results of Monte Carlo simulations varying parameters like the gross rate of return, real wage growth and the number of children (significant for the pensions to be expected by women). The graphs below (figures 2 and 3) show the probability distribution of replacement rates (in comparison to final salary) for men and women (assuming use of sex specific life tables in the second pillar). The median replacement rate for men was 51% and for women 33% (it was assumed that men work 44 years and retire at 65, whereas women work 39 years retiring at 60 (that is, both at present legal retirement ages). Of course, use of unisex life-tables would increase benefits for women and decrease those for men, but the high variability of the resulting replacement rates would remain unchanged.

projection, based on long-run modification of the Polish social policy budget model, originally developed by the Gdansk Institute for Market Economics together with the ILO, do not include fiscal effects of the minimum pension guarantee and future costs of social assistance for the elderly not entitled to minimum pension (one has to have 20 or 25 (women/men) years of contributions to be entitled to minimum pension). This would amount most probably to at least 2.5% of GDP by 2050 if not more. Hungarian projections also most probably exclude future cost of social assistance to the elderly not fully covered by the reformed system.

¹⁵ One of the reports shows replacement rates decreasing by more than 20 percentage points: for those retiring at 65 from over 60% for those in a cohort born in 1949 to about 40% for a cohort born in 1974. For those retiring at 60 (current minimum retirement age for women in Poland) replacement rates would go down from over 50% for a cohort born in 1949 to about 30% for a cohort born in 1974. See: A. Chlon-Dominiczak, The Polish pension reform of 1999, in: Pension reform in Central and Eastern Europe, Vol.1, op.cit., p.128. There are other reports showing similar results (like the ones from Pension Fund Supervision: Stopy zastapienia. Projekcje stóp zastapienia w nowym systemie emerytalnym, UNFE, Warszawa 2002 and Wysokość emerytur w nowym systemie ubezpieczeń społecznych, Departament Analiz, Komunikacji Społecznej i Informacji, KNUiFE, Warszawa 2003 or like in the report by the Polish Supreme Chamber of Control: Informacja o wynikach kontroli realizacji postanowień ustawy o organizacji i funkcjonowaniu funduszy emerytalnych, NIK, Warszawa 2002.

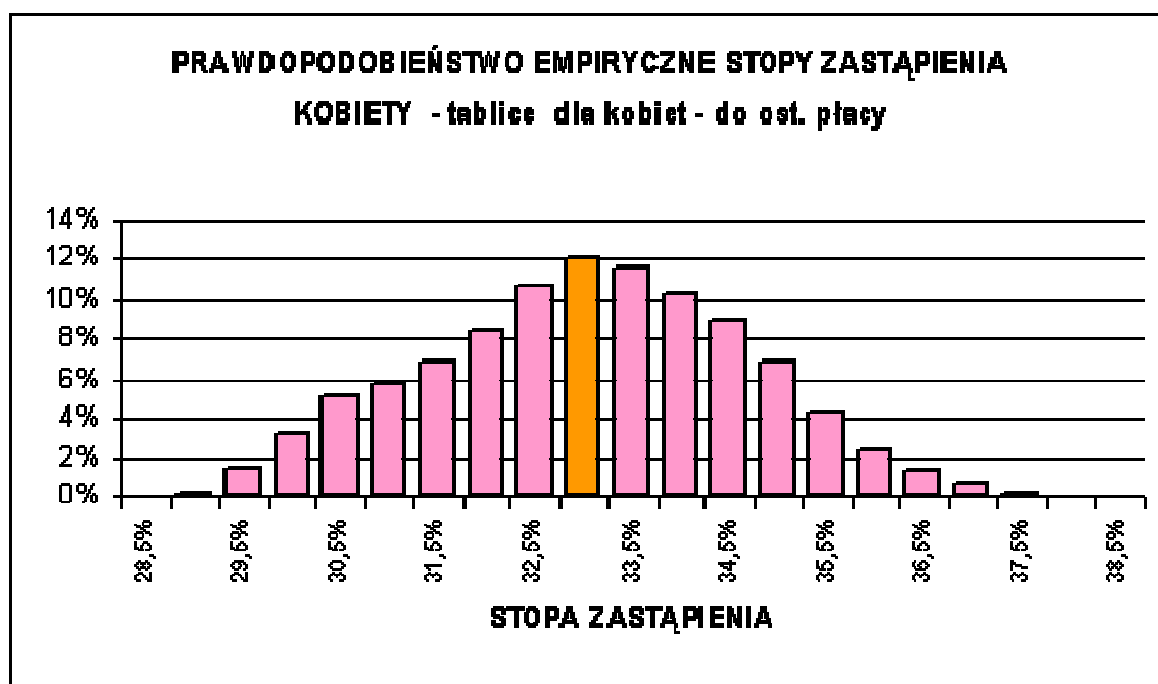
¹⁶ Stopy zastapienia, op.cit.

Figure 2. Empirical probabilities of replacement rates for men



Source: Pension Fund Supervision: Stopy zastąpienia. Projekcje stóp zastąpienia w nowym systemie emerytalnym, UNFE, Warszawa 2002

Figure 3. Empirical probabilities of replacement rates for women



Source: Pension Fund Supervision: Stopy zastąpienia. Projekcje stóp zastąpienia w nowym systemie emerytalnym, UNFE, Warszawa 2002

Fiscal implications of the reform and time inconsistency effect. While the discussed type of pension reform is expected to reduce public pensions expenditure in the long run, its immediate effect, lasting however for a long time, is actually to increase the

burden for the public budgets. The gap in financing *today's* pensions in payment and the *future* pensions of those who, at the moment of the reform, had accrued already some pension rights (by rerouting part of the social security contributions to individual accounts), has to be covered by the government out of tax revenue or additional borrowing. The size of these so-called “transition costs” was certainly in all the countries a major criterion in deciding on the size of the “second”, fully funded pillar.

Both Poland and Hungary decided that about one third of the total old-age pension contribution will go to the private pillar. (In Hungary 9%, in Poland 7.3% of gross earnings. Taking into account the shares of gross wages in GDP, the above, in both countries, implies an annual financing gap of about 3-4% of GDP to be covered by the government. This gap is small at the onset as only relatively young workers join the second pillar but it is bound to grow gradually up to the mentioned level. The financing gap will decline only after a significant number of persons start receiving (lower) pensions from the new system and, thus, the deficit of the PAYG pillar decreases.

The Ministries of Finance in both countries accepted fiscal coverage of the gap – but a precise formulation of the financing obligations for each years state budgets has not been legislated.¹⁷ This lack of clear rules about the fiscal implications of the pension reforms led in both countries to events that may serve as textbook examples of time-inconsistency of policies. As soon as reforms started to be implemented and actual budget allocations had to be made, enthusiasm for financing the reform costs faded away. As a result, in Hungary, where the reform started in 1998 with only 7% of gross wages going to private pension funds and the law foreseeing annual step-wise increases - 8% in 1999 and 9% in 2000 – this provision was suspended already in the first year of the reform and only recently (2004) it reached the foreseen target. This suspension saved the state budget more than 0.5% of GDP each year but was met with rather angry reactions from the pension funds and the financial sector.

In Poland, although there were voices calling for decreases of the part of contributions going to private pillar, the strategy undertaken by the fiscal authorities was rather to pay a smaller than necessary subsidy to the Social Security Institution (ZUS), which administers the first pillar but collects the contributions for both pillars (ZUS is expected to make appropriate transfers to the private pension funds.). ZUS, rightfully, treats payments of

¹⁷ The issue was raised in report from the analysis of the implementation of the pension reform done by the Polish Supreme Chamber of Control, NIK, 2002, op.cit. The same body also pointed out that widely advertised law supposed to earmark proceeds from privatisation to finance costs of the pension reform, was actually never implemented.

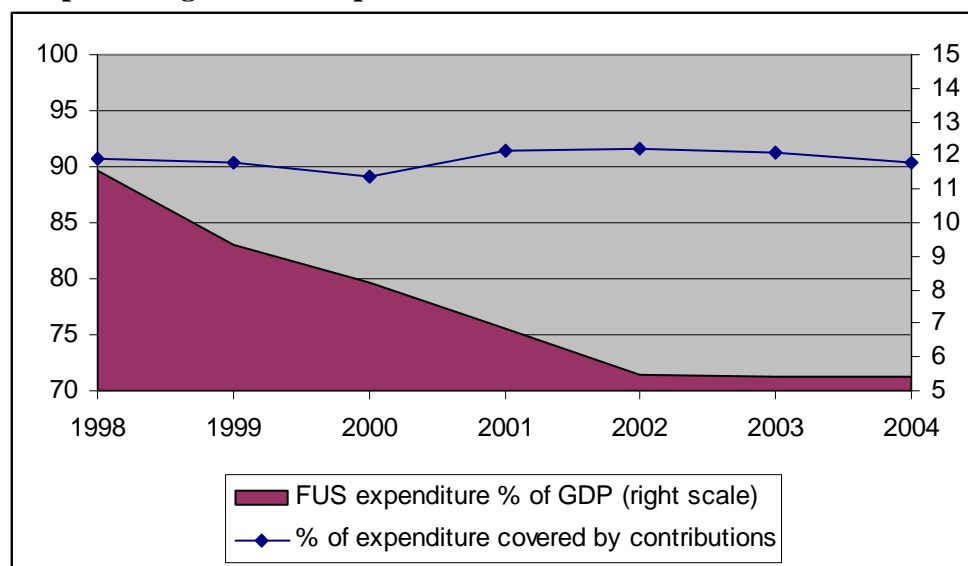
current pensions with priority, and, thus, transfers to private pension funds smaller amounts than due. The effect is, of course, similar to what happened in Hungary, although the size of the reduction in contributions is smaller. And - at least in theory - all contributions in arrears should be paid sooner or later. Private pension funds were equally unhappy like the Hungarian ones, but all blame went on ZUS and not on the government.

Poland, like other countries now members of the European Union and hoping to enter the Euro zone, struggle with attempts to keep their public deficit within the limits imposed by the “Stability and Growth Pact” (among others: maximum 3% of GDP). The size of fiscal implications of the pension reform thus is more or less equivalent to the size of the public deficit allowed by the Maastricht criteria. But Poland already had deficit close to 3% of GDP even before the reform, which means that in the medium term the only source of financing the financial gap caused by pension reform will have to come from cuts in other public spending¹⁸. It is thus not especially surprising that those responsible for current public finances are trying to reduce the actual burden of the pension reform.

The amount of contributions transferred as a result of the reform to private pension funds forms the major but not the only part of the fiscal implications of the reform. In the Polish case there are two other significant elements resulting in additional state budget financial obligations, although they are not particularly linked to the existence of the funded pillar. The first comes from the fact, that the reform also introduced a ceiling on earnings subject to contributions, setting it at 250% of average earnings. The state budget subsidy to ZUS aimed to fill the financing gap caused by the ceiling amounts to 0.4% of GDP every year. The second results from the new state obligation to pay pension contributions on behalf of some of the beneficiaries of welfare benefits. The respective costs amount to about 0.2% of GDP. Figure 3 shows, that although FUS expenditure as percentage of GDP was quite stable since 1998, the share of this expenditure backed fully by the contribution revenue has significantly declined, the remaining gap being covered from the state budget).

¹⁸ There were hopes that financing gaps arising as a consequence of pension reforms might be statistically treated in a way, which would not add it to general government deficit. The blow to this hope was given by the EUROSTAT decision announced in March 2004 on “Classification of funded pension schemes in case of government responsibility or guarantee”. The decision specifies that defined contribution funded pension schemes should not be treated as a social security scheme, with the consequence that the flows of contributions made to the scheme and of pension benefits paid by the scheme are not recorded as government revenue or as government expenditure and, therefore, do not have an impact on government deficit or surplus. It thus means that any portion of social security contributions rerouted from a PAYG scheme to a funded scheme actually decreases recorded general government revenue and thus increases the recorded deficit. See: EUROSTAT News Release, no 30/2004, 2 March 2004.

Figure 3. Poland: Social Insurance Fund: total expenditure as % of GDP (right scale) and percentage of total expenditure covered from contribution revenue



Source: own calculations based on data from ZUS, <http://www.zus.pl/statys/stat02.htm>.

The reform-related financing gap adds to the pressures coming from the budgetary needs related to EU membership (although new member countries can expect significant inflows of EU funds, they have to restructure significantly their public expenditure before becoming eligible) and from the policy goal of joining the Euro zone as soon as possible. Sooner or later this policy will have to result in significant reductions in expenditure and – as social expenditure consumes the majority of all public spending – particularly reductions in expenditure on many social programmes. In Poland, the debate about a “crack in the budget” has been continued since year 2001¹⁹ and a comprehensive programme of significant reductions in various social programmes is in the final stages of the parliamentary debate (June 2004).²⁰ Scope and magnitude of proposed reductions is shown in Table 1. It has to be noted that the overall financial impact of those measures in the medium term will balance only about one third of the overall fiscal costs of the pension reform but their perceived social impact is so strong than it is still uncertain whether there will be a sufficient political majority to support it.

¹⁹ Somehow however, not many of the participants in these debates associate the sources of the gap with the pension reform. This proves once again the strength of the political support for the reform.

²⁰ Plan for the Rationalisation of Social Expenditures, Ministry of the Economy, Labour and Social Policy, January 2004, <http://www.mpips.gov.pl/english/index.php?dzial=45&poddzial=72&dokument=58>.

Table 1. Expected reductions in social expenditure as a result of implementation “Hausner plan”(% of GDP)

	2004	2005	2006	2007
<i>Reduced indexation of pensions and reduced sickness benefits</i>		0.2%	0.5%	0.2%
<i>Reductions in pre-retirement benefits</i>		-0.1%	-0.1%	-0.2%
<i>Restricted eligibility to disability pensions</i>		-0.1%	-0.2%	-0.2%
<i>Reduced financial support to a scheme promoting employment of persons with disabilities</i>	-0.1%	-0.1%	-0.2%	-0.2%
<i>Changes in social security system for farmers</i>		-0.2%	-0.2%	-0.2%
TOTAL	-0.1%	-0.8%	-1.2%	-1.0%

Source: own calculations based on: Plan for the Rationalisation of Social Expenditure, Ministry of the Economy, Labour and Social Policy, January 2004, Table 2, p.25

<http://www.mpips.gov.pl/english/index.php?dzial=45&poddzial=72&dokument=58>

What in the future? Some observers see the expected radical cuts in pension levels as element of the reform success²¹. Many, however, are worried about the future levels of benefits, about their adequacy and safety. Poland just (in 2004) ratified ILO Convention 102 on Minimum Standards in Social Security, including its old-age chapter. The Polish new pension system – in its current shape - will not be able to provide to all its members pensions at the minimum levels required by this Convention - even after relatively long periods of contribution payment.

There is also an imbalance between the ability of the reformed pension system to contain pension expenditure in the longer run (although in the medium term they put public finances under a strain) and its ability to provide adequate pensions, which – according to the EU documents – requires any national pension system to:

- *“Ensure older people are not placed at risk of poverty and can enjoy a decent standard of living; that they share in the economic well-being of their country and can accordingly participate actively in public, social and cultural life;*
- *Provide access for all individuals to appropriate pension arrangements, public and/or private, which allow them to earn pension entitlements*

²¹ “Poland belongs to a non-numerous group of countries that are prepared for one of the most difficult challenges of our time, namely the ageing of the population. The new pension system will not only stop the increase of costs of the pension system but will also allow for their reduction. This will leave more resources available for development, which, in turn, will contribute to stronger growth and the increase of living standards of both the working and the retired generation. M. Gora, ” Reintroducing Intergenerational Equilibrium: Key Concepts behind the New Polish Pension System, William Davidson Institute Working Paper Number 574, June 2003, p.25.

enabling them to maintain, to a reasonable degree, their living standard after retirement; and

- *Promote solidarity within and between generations.*”²²

A pension system is viable only if both its broad objectives – adequacy and financial sustainability are ensured. Inadequate benefit levels may eventually undermine also financial sustainability of the whole pension system, discouraging the active population from contributing and forcing governments to allocate additional resources to alleviate poverty among inactive population. There are thus serious doubts whether the new Polish pension system actually provide effective and sufficient instruments to cope with population ageing.

One has to act now, because in the defined contribution pension system future benefit levels are shaped over the decades of contributions paid and are difficult to be corrected *post factum*.

First, missing regulations have to be enacted quickly. New law deciding on the rules of payment of pensions from the second pillar should be put under the public debate as soon as possible. Decisions concerning how and by whom pension from the second pillar will be paid and how these benefits will be indexed should aim primarily at increasing potential benefit levels and minimizing administrative costs. Additional measures to force reductions in the administrative costs and charges by the open pension funds are also necessary.

Second, the question of increasing the legal retirement age should be put also under the public discussion. Potential incentives within the reformed system might be too weak and gradual increase of the minimum retirement age may be also necessary.

Third, rules for indexation of current benefits should be changed, so that pensioners are also allowed to have their share in the economic growth. Indexing benefits only along price increases is not viable in the long run.

Fourth, corrections in the first, NDC, pillar, have to be made. Rate of return of the notional capital should be set rather at the level equal to rate of increase of average earnings and not of the sum of wages subject to contributions. Demographic and labour market projections show number of insured will be decreasing in the long term and without above change the actual rate of return of the NDC pillar would be lower than average wage growth.

Fifth, there is a need to build into the pension system safeguards preventing benefit to fall below the desired levels and at least below the levels required by the ILO Convention 102. Taking into account long-term demographic trends preventing benefits from falling

²² EU Commission, “Quality and viability of pensions – Joint report on objectives and working methods in the area of pensions”, Brussels 2001, p.6

below these levels will not be possible within the current level of contribution rates. One has thus to be aware that in the future there will be a need for additional financing – either by increase in contribution rates or through additional earmarked taxes or from the general taxation. Source of additional financing will depend also on what kind of safeguards will be built in to prevent pensions from falling below the desired level. This can be done either within the contributory part (then increase in contribution rate will be necessary) or through universal guarantee of the minimum pension financed from the general taxation. Current provisions with respect to the minimum pension guarantee are neither sufficient (minimum pension would have to be indexed to wage increase) nor fair (general taxation financing should not be limited only to those with long contribution record over 20/25 years).

And finally: it is most important to ensure that there is a well-informed public debate on the above policy choices. Decisions about the future pension systems should not be left to narrow circles of experts and powerful but narrow interest groups. Pension policy, like all economic and social policy should be shaped in an open democratic process where participants are aware of the long-term consequences of their decisions and where interest even of the weakest groups are well represented.