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Direction of change in the pension systems in Eastern Europe

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Abstract

Pension costs are a considerable expenditure of every government and are not sustainable in their present form. The crisis has brought it to attention – but arguably not to the degree it would necessitate. Structural changes to the pension systems are thus rare and hard to come by. Most countries have started minor changes in the system, adjusted their pension ages, indexed the pension age to life expectancy or pension payments to pension contribution (defined contribution plans – for individuals or throughout the pension budget), others have started scrapping special pension benefits and revisited the issue of incapability benefits.

This paper is about the unorthodox measures adapted in the reform of the pension schemes – most pronounced of which is the de facto nationalisation of the Hungarian mandatory private pension funds' assets to balance the 2011 budget. Most important in this light is the change on the proportion of public as opposed to private contribution and self-reliance in various pension systems.

Keywords— Eastern Europe; Pensions; Fiscal policy

JEL— H55; H6

HUNGARY

The restructuring of the Hungarian pension system during 2010 happened as follows – leaving out the discussions, aborted plans and most of the rhetoric that went with it.[1]

Since the European Union does not allow the preferential accounting of budget deficit incurred by the pension shortfall due to the introduction of the private pension funds – but also demands a less than 3% deficit as part of the inflexible Maastricht criteria, the Hungarian government decided to abolish the achievement of the mandatory private pillar of the pension system (established in 1998) and to get hold of its assets.

According to the argument pension funds were extremely wasteful (due to lack of regulation), and their investments can hardly turn a profit if they invest in an ageing society with decreasing productivity. But allowing them to export capital to developing countries would be equally fatal economically. (This consideration, however, has completely escaped other countries without a capital market of their own – like Slovakia.) Private funds have also made huge losses during the crisis – not least because they were legally obliged to start moving their portfolio away from government bonds and into shares and other assets exactly by the time prices peaked before the crisis. Their losses were high on the (often populist) list of arguments against them.

To ensure the "voluntary" return to the public pension scheme, individuals were faced with the choice of either staying in the private pension fund – and lose all future public pensions for which they have to keep contributing nonetheless – or return to the public (pay as you go) pension pillar and lose ownership of their private pension savings amassed so far. To ensure the results, returning to the state pillar was set as default if the individual failed to declare otherwise. In the meantime, staying in the private pillar was denounced as "unsubscribing from the social contract" by leading politicians. The one-off payout of the real return of their

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[1] The first attempt to bridge the pension shortfall in the budget was to divert private pension savings for a period of 14 months (November 2010 – December 2011) – without specifying what would happen afterwards. Similar moves were made in Poland and the Baltic states, although in each case the governments obliged themselves to return the amount with interests after the end of the period.

savings was meant to sweeten the pill – even though the calculation of this return was extremely vague and suffered from heavy lobbying. It was also meant to demonstrate how little return the funds have made so far. (The payouts in 2011 have appeared in a one-off hike in the otherwise declining retail sales which then continued abating.[2])

Eventually only three percent (roughly 100 000 people) have stayed in the private pension funds – low enough to risk their profitability – and awaiting further regulation, possibly to worsen their position. The contribution these members (and their employers) are still required to pay has changed into a form of tax so that it does not qualify them to either years spent in service, nor public pensions in the future. This contribution-turned-tax is approximately 75% of all pension contributions by an employee.

The HUF 2700 bn has then been transferred to a state fund for "reducing public debt and reforming pensions" – with its assets awaiting being sold on the market. Management of these assets is crucial to the future of the stock index and all companies present in their portfolio.

EXAMPLES IN EASTERN EUROPE

Facing the same dilemma over the accounting of the pension shortfall in the budget deficit Poland (2.3%), Estonia (0%), Romania (2%), Latvia (2%) and Lithuania (2%) have all temporarily cut or ceased payments into the private funds with a promise to return the sum with interests, while the Czech Republic has embraced the support for the second pillar in the same period.

Most analysts have come to the conclusion that the situation of private pension pillars, pre-financed by international loans is extremely uncertain, especially when it comes to other targets like adherence to the one size fit all Maastricht criteria on public debt and budget deficits. (Velculescu, 2011)

[2] Source: http://hvg.hu/gazdasag/20111021_realhozam_kiskereskedelem

CZECH REPUBLIC

The recent Czech pension reforms took the opposite direction in that the Czech Republic is planning to set up its private pension pillar. The Czech pensions-to-GDP ratio (8.5%) is better than the European average (11.7%) in 2008, but the pension reform is crucial to the sustainability of the public debt. The bill is the Czechs' first major attempt to overhaul their publicly funded pension system since the fall of communism. It will allow workers to voluntarily divert 3% of the 28% social insurance tax, which they currently pay into the public system, into privately administered funds instead. They must supplement that with another 2% of their salaries. The opt-out cost will be covered by unifying two separate rates of value added tax at 17.5% in 2013, triggering opposition.

Investors have mostly welcomed the plan and say it sends a better message than the seizure of pension assets by Hungary's government and Poland's diluting of the privately funded portion of its pension scheme to plug large present budget deficits. But the Czech reforms are weaker than originally hoped and fewer people may subscribe due to its voluntary nature, which means planned budget consolidation goals may not be reached. [3]

The rate of contribution should increase to 5% by 2019. It would cost CZK 30billion to the budget in 2013 and its cost would either be covered through increased VAT on certain items, a single 19% VAT rate, or the profits of the state-owned Czech Energy giant (CEZ). [4]

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[3] Source: Fölpuhult a cseh nyugdíjreform. Portfolio.hu 19 February 2011 http://index.hu/gazdasag/2011/02/19/a_magyar_pelda_miatt_puhult_fol_a_cseh_nyugdireform/ Czech Republic kicks off pension reform, 14 July 2011 http://www.euractiv.com/socialeurope/czech-republic-kicks-pension-reform-news-506552

[4] Source: Jirák, Pavel: Pension System Reformin the Czech Republic EBRD Research, 1 April 2011 http://www.ebrd.com/downloads/research/news/RT_1_Jirak.pdf

A csehek a magánpénztárakba tesznek pénzt az államiból, Világgazdaság, 18 February 2011 http://www.vg.hu/gazdasag/gazdasagpolitika/a-csehek-a-maganpenztarakba-tesznek-penzt-az-allamibol-341325

and ODS calls government partners to agree to real pension reform, The Prague Monitor, 18 January 2011 http://praguemonitor.com/2011/01/18/ods-calls-govt-partners-agree-real-pension-reform

SLOVAKIA

Slovakia already has a three-pillar pension system but aims to strengthen its private pillar nonetheless. The second pillar could become mandatory for new entrants of the job market – but allow them to leave in the first three years if they are unconvinced. Contributions to the third, voluntary savings pillar would, however, stop enjoying tax cuts and exemptions. [5]

The 2010 results of the Slovakian pension funds were bleak. Funds blame the regulation of the Fico-administration for the lower than inflation returns. The previous Fico-cabinet had obliged the funds to conduct mark-to-market valuations twice a year (as opposed to every five years under previous regulation) and top up the funds if there are losses to the customer. This had drastically reduced their appetite for risk.

The Radicova-government would support the second pillar but made the savings in the third pillar subject to taxes as part of the austerity package. The approaching general elections in early 2012 could bring a change in this approach.

POLAND

The second pillar was created in Poland in 1999 as a part of a pension overhaul – in 2010 it caused a 22.5 billion zloty shortfall to the state pillar funded by the budget.[6] Poland has been facing the same dilemma regarding the accounting of their pension shortfall in 2010 but solved the problem by the controversial step of temporarily diverting contributions to the second pillar. The step, however, was less radical than the Hungarian example because it wasn't followed by seizure of their assets.

Before 2010 the first pillar contribution was 12.1% of gross salaries in Poland. As part of the reform, the second pillar contribution was reduced from 7.3% to 2.3% - the state pension

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[5] National Reform Programme of the Slovak Republic for 2011-2014, April 2011 http://ec.europa.eu/europe2020/pdf/nrp/nrp_slovakia_en.pdf

[6] Velculescu, Delia: Pension Reform in Emerging Europe – Te Uncertain Road Ahead, IMF 1 April 2011 http://www.ebrd.com/downloads/research/news/Velculescu.pdf

fund receives the rest. Until 2017, when it would grow back to 3.5% - still far from the original level of 7.3%.

The aim is to reduce deficit and thus the public debt – a rise of which above 55% of GDP is against the Polish constitution. In 2010 it grew to 53.2% of GDP while deficit was at 7.9%. According to the government's calculation debt would be as low as 40% of GDP if only its pension liabilities weren't part of it. Former communist countries have often proposed to Brussels to exempt their pension shortfall from the Maastricht deficit criteria – without any result. Poland has achieved that it would be taken into account during the excessive deficit procedure in the future.[7]

[7] On top of the private pension funds, the 1999 pension reform in Poland has created a Demographic Reserve Fund (FRD) in order to balance the demographic shortfall. The Polish government has in 2010 allowed for the second time to release money from the fund in order to cover current pension expenditure – triggering opposition and trade unions to denounce its irresponsibility. (The Fund received 0.1% of the pension contributions at the beginning – gradually meant to increased to 1%. This, however, has been halted by 0.35% because no government has ever honoured this target. Source: Tartalékalapból fizetik a nyugdíjakat Lengyelországban, August 2011 http://kitekinto.hu/europa/2011/08/18/tartalekalapbol_fizetik_a_nyugdijakat_lengyelorszagban/

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