Security
through
Diversity

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The new Polish old-age pension system: A very brief description

Poland started the new mandatory old-age pension system called "Security through Diversity" on 1 January 1999. For people born after 31 December 1948 the new system entirely replaced the previous one that had been terminated on 31 December 1998. People were covered by the new system automatically – there was no decision whether to switch to the new system or not.

Key features of the new system are:

- focusing on mandatory part of the system,
- separation of the old-age and non-old-age part of the system,
- converting entire old-age part of the system into defined contribution regime,
- splitting the old-age contributions into two pieces to be managed in different ways,
- keeping both parts of old-age system closely linked to each other.

The new state old-age system consists of two parts. Using the same terminology as applied in the case of the new Swedish pension system we can call these parts: pillar 1A and pillar 1B. [Comment: The new Polish pension system is very similar to the new Swedish pension system.] They are financed out of the same mandatory contributions as the previous system. Both elements of the new system are newly established – none of them is a continuation of the previous system. The new system manages the same public money in a different way. Table 1 provides details.

Table 1. Mandatory contributions in Poland before and after implementation of the new pension system

	Total	Individual account No.1	Individual account No.2	Other elements of the system
before 1-Jan-1999				
Mandatory contribution	36.59[2]	--	--	36.59
since 1-Jan-1999				
Mandatory old-age contribution	19.52	12.22	7.3	--
Other mandatory contributions	17.07	--	--	17.07

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[2] Equivalent of 45 percent (after grossing-up).

On the day of retirement claims accumulated in both individual accounts (sum of contributions paid plus interest) are recalculated into annuities. There is no other option.

Paying contributions into both accounts, as well as using claims accumulated in the accounts for financing benefits are subject to the same general regulations. In particular:

- contributions are collected together through the same channel;
- contributions paid create claims;
- accumulated claims equal contributions paid plus interest due;
- on the same day claims from both accounts are used to calculate annuities;
- the minimum pension guarantee is defined as pension supplement paid out of the state budget on the top of the sum of annuities calculated on the basis of claims accumulated in both accounts.

Polish pension reform is not focused on privatisation of social security. From the point of view of goals it stays unchanged. Mandatory contributions are paid into the state pension system, and afterwards are used to finance old-age pensions. This is now being achieved using methods different form the ones used previously. Individual accounts No.1 are managed by a public institution. It is possible this institution will be privatised in the future. Managing individual accounts No.2 have been contracted out to private firms.

The new old-age pension system means is entirely based on two types of individual accounts. Design of the new system assumes entire active population being covered by the new system and old-age contributions being split between the two accounts. That target is to be achieved after a transition period. Initially only people younger than 50 (born after 31 December 1948) were covered by the new system. They did not have an option to stay in the old system. People who in 1999 were 50 and older stayed in the old system. They – in turn – did not have an option to enter the new system. Of the younger group that was covered by the new system, those who were born after 31 December 1968 had their old-age contributions split between the accounts automatically; those born before 1 January 1969 (but after 31 December 1948) had an option to choose one of two versions of the new system, namely the target version with the old-age contribution split between the two individual accounts (account No.1 and No.2) or the transition version with only one individual account (account No.1). Phasing-in of the new system goes along the schedule illustrated in Scheme 1.

Scheme 1. New old-age pension system phasing-in schedule

Born after 31-Dec-1968	Born after 31-Dec-1948 and before 1-Jan-1969	Born before 1-Jan-1949
mandatory entry into the new system -- two individual accounts	mandatory entry into the new system -- one or two individual accounts	stay in the old system -- no accounts
New mandatory old-age system		**Old system**

Both types of individual accounts run within the state system bring rate of return. However, there are different ways of generating the rate of return in each of the accounts. Account No.1 is linked to dynamics of the aggregate contribution base (the so-called notional defined contribution system, NDC). Account No.2 (managed by private firms called pension societies) generates the rate of return in financial markets.

Managing a part of public money through financial markets needs some precautionary measures – especially in the initial phase of operation of the new system. This applies mainly to open pension funds portfolio structure. The intention is step by step relaxation of these measures. The step by step approach is applied since the precautionary measures play an important psychological role for people mandated to have their money paid to private firms managing a part of the state system.

One of the precautionary measures imposed on pension funds is limitation of a portion of the assets they manage that can be invested abroad. The limit is very low (only 5 percent of total assets) at the moment and it should be lifted. It will be very rational if it is lifted 5-10 percentage points per year for investments within the OECD area. There is no reason for prohibition or strong limitation of investment of this element of public finance in international financial markets. Just the opposite, more foreign assets in pension funds' portfolios will improve their diversification which will reduce risk, hence bring additional security for future pensioners.

Transition to the new old-age pension system creates temporal deficit in the old system. More precisely, introduction of the part of the system based on the account No.1 does not create any open deficit. Introduction of the part of the system based on the account No.2 does. The deficit in the old system is covered out of the state budget. In turn, additional state budget deficit is financed out of privatisation revenues. Although introduction of individual accounts No.2 leads to an increase of the state budget deficit, no or very little additional inflationary pressure is created since money used for covering the deficit do not appear in the consumer market.

Additionally, in Poland exists a large variety of supplementary pension schemes. They are outside and on the top of the mandatory state old-age system. These arrangements include occupational pension schemes and other group or individual schemes. Opposite to paying contributions to the mandatory system (individual accounts of both types) participation in these supplementary schemes is voluntary. These are purely market and private arrangements. The state supervises them but does not impose substantial limitations on their activities. All existing regulations on these supplementary pension schemes can and should be fully adjusted to EU standards.

References

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