

The Battle Over Private Pensions

By Luca Barbone

Funded, compulsory pension funds are under attack in Europe and elsewhere in the world. But are recent policy actions likely to improve the lot of future pensioners, or will they turn out to be short-term politically-motivated fixes that ultimately make life harder?

Partly as a consequence of the global financial crisis, pension reform has again been thrust into the forefront of public debate across Europe. The fiscal consequences of the deep recession brought first-pillar systems to a state of crisis and in many instances re-opened unfinished parametric reforms (involving pensionable age, special regimes, indexation mechanisms, etc.), often with very contentious political debates (Poland, Serbia, Ukraine, Bosnia, Turkey, etc.). Following the early example of Argentina in 2009, a number of countries have taken steps to “re-publicize” second-pillar institutions in order to increase the short-term financing of public expenditures, or to reduce recorded levels of debt.

The most notable actions have taken place in Hungary (which nationalized its pension funds, eliminating *de facto* the second pillar), Latvia and Lithuania (which reduced second-pillar contributions), Estonia (with a temporary redirection of state contributions from second to first pillar in 2009 and 2010), Romania (which postponed planned increases in second pillar contributions in 2010) and Poland – which proposed reducing second pillar contribution by two-thirds (albeit with the possibility of an increase in the future). Are these actions the result of a re-examination of past reforms, or are they the manifestation of political expediency in the face of new fiscal realities? What does this signal for the future of funded pension schemes—and more importantly, for future pensioners in Central and Eastern Europe?

Reforms: Motivations and Dangers

Over the past twenty years, virtually every country in Central Europe and the former Soviet Union introduced pension reforms (as have many countries in the EU15 and beyond).

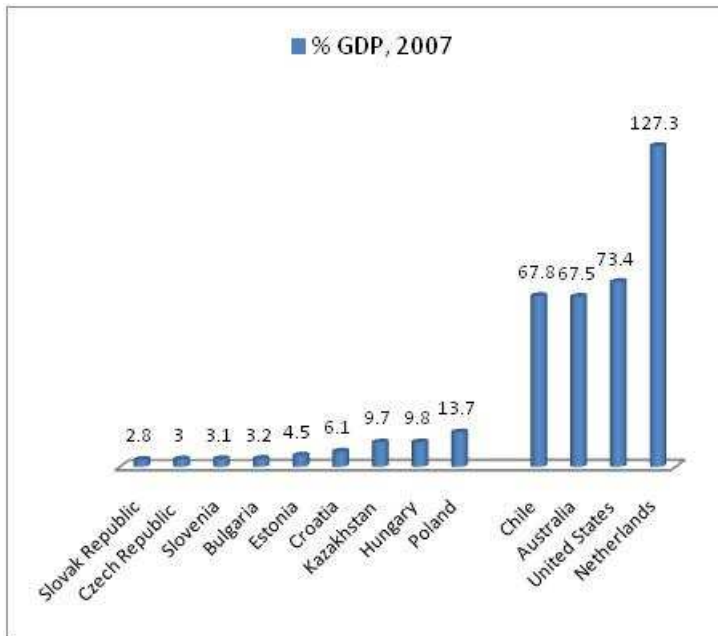
The reforms have taken many shapes, reflecting specific country circumstances, national consensus and priorities, the development of financial markets and regulatory capacities. Every country attempted to revisit pensionable ages, indexation rules, special regimes; in some, “point” systems were introduced, linking final pensions to contributions, albeit within the confines of pay-as-you-go (PAYG) systems. Among the EU10, the European Union’s (EU) newest Central European members, most countries introduced compulsory defined-contribution systems with varying rules regarding contributions, eligibility and fund management schemes. Only the Czech Republic and Slovenia refrained from this experiment.

Reformers had several rationales for the switch to a multi-pillar system, and for the introduction of a defined-contribution second pillar. Unfavorable demographic trends were certain to make fulfilling obligations to future pensioners of unreformed PAYG systems impossible. Many countries also had to deal with significant budgetary crises, partly stemming from pension systems that had been used as an “escape valve” to facilitate the economic transition of the early 1990s. Reforms attempted to deal with these issues and were influenced by debates over the future structure of social safety nets, including Chile’s 1980s reforms as well as the World Bank’s strong stance on the adoption of three-pillar systems.

The adoption of a two/three pillar system was thought to bring several benefits. First, switching part of the contributions to a defined-contribution scheme (thus reducing the promised pensions from the first pillar) would reduce the future burden on public finances, and better prepare for the decline of the contributor/pensioner ratio. Secondly, newly established privately managed pension funds would lead to the emergence and deepening of capital markets in reforming countries, and higher rates of return for

contributors. This would ensure payouts that could complement the pensions paid out by the (reduced) first pillars, and allow for a decent income during retirement. Lastly (but most times only implicitly) the funded schemes would reduce the scope for politicians to alter pension contracts for political gain—defined contributions schemes could not be so easily manipulated.

FIGURE 1: FUNDED PENSION FUNDS



Source: World Bank*

Reformers were also open to the risks involved. Financing the second pillar during the transition period would involve fiscal costs. Since first pillars were PAYG systems, devoting part of the contributions of the working population to the second pillar—while continuing to pay pensions to the “stock” of pensioners entitled to them (and to those entering during the period of transition)—creates a deficit in the first pillar accounts, that needs to be financed. Proponents of the multi-pillar system argued that such deficits would in reality represent bringing forward (part) of the unfunded liabilities implicit in the existing pension schemes.

Questions were also raised regarding the adequacy of domestic capital markets to accommodate the flow of private savings and to provide adequate returns to pensioners. With all these caveats, it was also clear that the second-pillar reforms were being introduced with a long-term horizon: the adequacy of the retirement income provided by the revamped systems could only be judged in a matter of decades, when combined pension system payoffs could be evaluated.

A Short History: Failed Experiment or Politicians at Work?

The funds have been in operation for a number of years now, and they have accumulated sizeable assets—albeit a relatively small amount compared to earlier adopters in countries with more advanced capital markets (fig. 1). The funds remain in the inception phase: payments to pensioners have only occurred for small numbers of women in Poland and Hungary. Typically the reforms forbade or discouraged, depending on the country, those with less than 10 years before retirement from joining the second pillar.

What then are the grounds for criticism regarding the recent attacks on the funds? Critics point to unfulfilled promises in two areas mentioned above. First, the transitional costs have turned out to be greater than expected—and this has been compounded, in the views of some, by the EU’s rules concerning public debt limits under the Growth and Stability Pact. Second, returns on investment in the second pillar have arguably been low, on account of general economic conditions and of excessive management fees by investment funds. These are two real problems, but each with facets that are somewhat different.

With regard to transitional costs, it should be pointed out that while initial estimates might have been optimistic, the excess costs also reflect the “success” of the second pillars, in that more people that had the option to join or not chose to do so, thus increasing transitional costs. For instance, in Slovakia 100,000 workers were expected to switch to the two-pillar system after the implementation of reforms in 2005, but in reality 400,000 did. In Poland, due to reforms in the first pillar that eliminated special benefits, many more people chose to become pensioners than had been anticipated.

But is this an argument against funded schemes—and does it provide a rationale for scaling-down contributions or even re-nationalization? Taking for granted that transition costs may have been higher than expected, they have to be seen in the context of overall trends in public finances. In the decade leading up to the financial crisis of 2008, buoyed by exceptional revenue growth on the heels of high but unsustainable GDP growth rates, public spending in Central and Eastern European (CEE) countries ballooned (in real terms) way beyond the extra costs imposed by transitions to a multi-pillar system. In other words, profligate and vote-seeking politicians had their cake, and ate it too. Accusing the EU of rigidity and short-mindedness misses the point.

The second issue is also more complex than often portrayed. Opponents of funded schemes point to high management fees, resulting in low returns for contributors. This reasoning is not new, and indeed over time several changes to the management arrangement of pension funds have been instrumented to reduce excessive turnover costs and management fees.

In CEE countries, however, restrictions on allowed investments have been binding, and have resulted in a heavy concentration of assets in government bonds. For example, Poland initially did not allow foreign investment at all (but smaller countries, such as Estonia, had little choice other than investing heavily abroad). It was actually the decision by pension funds in Hungary to try to diversify their portfolios and offer life cycle options for contributors and their consequent unwillingness to buy more government bonds that partially precipitated nationalization in Hungary. Restrictions on investment portfolios may have been justified, at least for a period of time, by the shallow nature of capital markets in CEE countries. But this points to a catch-22 situation: pension funds are forced to invest in low-yielding securities, and then charged with the crime of not returning adequate yields!

Catch-22: How to Exit?

What should be done to address these criticisms and to revitalize funded schemes? The answer is not simple. For instance, an influential World Bank report issued a couple of years ago noted that, several years into the functioning of second pillar schemes, a loaded agenda for reform remained in many CEE countries to ensure that the benefits of the funded schemes could be realized. The agenda is complex: it deals with the preconditions that would allow the pension funds to earn real returns in excess of those that can be promised by unfunded schemes, and that would also ensure that, in the *withdrawal* phase of the funds' lifecycle (i.e., when more funds have to be liquidated to pay for pensions than they accumulate contributions from workers) funds would be available to execute the payouts without disrupting financial markets. The technical parameters are reasonably clear, but there is a crucial point missing: the need for a determined advocate for improvement and continuous reform, in the face of difficult economic circumstances and populist politicians that have no investment in the long-term future of the pensioners.

Funded Pensions: Where to Now?

What conclusions can be drawn from this spate of policy news and continuing debates? One could say that prospects do not look good for public funded schemes. They have proven NOT to be immune from political interference—as a

matter of fact, as we saw, when growing sufficiently large, they have been treated as cash cows, with little public disapproval. In most countries, they have also become "orphans" as a result of the political process. Once the early reformers are gone, political expediency takes over and makes the temptation to dip into large accumulated funds almost irresistible. Witness the case of Hungary, where large politically-motivated pension increases in the first pillar prior to 2008 weakened public finances to the point that severe deficits appeared even prior to the financial crisis. Moreover, politicians (with a straight face) blamed the second pillar for disservice to pensioners, and proceeded to raid funds to fund one or two years of an otherwise unsustainable unfunded system.

If these considerations lead to a pessimistic outlook for pension funds, one should also, soberly, note that they leave unsolved the underlying problem for which they were thought to be part of the solution: the long-run insolvency of PAYG systems in the face of demographic trends over the next several decades. Is it perhaps time for a new breed of reformers to step forward?

* Bebczuk and Musalem, How Can Financial Markets Be Developed to Better Support Funded Systems? Ch. 2 in Holzman, Robert ed. (2009): "Aging Population, Pension Funds, and Financial Markets - Regional Perspectives and Global Challenges for Central, Eastern, and Southern Europe", World Bank, Washington DC, ISBN: 978-0-8213-7732-1

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