Pensions internationally

Pension reform in Central and Eastern Europe

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Abstract The countries of Central and Eastern Europe face profound problems in relation to state pension provision. Many have embarked on radical changes to their pensions systems. In many cases, national legislation now compels large sections of the working population to contribute to pension funds. Many countries have drawn their inspiration for mandatory pension funds from Latin America. There have been a number of successes in implementing pensions reform in Central and Eastern Europe but problems are faced in relation to investing fund assets, fraud and with the marketing of pension funds. This paper is based on a presentation made by the author at the Annual General Meeting of the EBRD in Riga, Latvia, on 20th and 21st May, 2000.

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Introduction

Since the collapse of the Berlin Wall at the end of 1989, the countries of Central and Eastern Europe have undergone profound and traumatic change. In many cases, the countries in the region have very much aimed to emulate Western Europe. This influence is particularly striking in the areas of privatisation, the introduction of securities markets and in deregulation. However, there is one crucial area where the countries in the region have not taken their lead from Western Europe but have instead looked to Latin America for inspiration. Much of what is now being implemented in terms of pensions reform draws its inspiration from the countries of Latin

America, but with changes made to reflect local market conditions and also to take into account perceived mistakes in the Latin American pension reforms.

Until recent years, the state enjoyed a virtual monopoly on pensions provision in all of the former centrally planned economies in the region. However, as in Western Europe, the need for reform is urgent. Most countries in the region face similar demographic problems to those faced in the West. However, few if any of the countries can afford the myopia which has afflicted so many Western European governments. A change in political attitudes combined with traumatic economic problems in many countries in the region has meant that

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governments have not been able to maintain the real value of pensions.

Many of the countries in the region have had the foresight to see their pensions crisis as an opportunity as well. In nearly every country there is a significant need for capital to help rebuild the economy. Indeed, in large part, the pension reforms have been predicated by a desire to boost local capital markets, with improvements in social welfare being very much a secondary objective.

The move towards compulsion

The move towards private pension systems began in earnest in 1993 when Hungary and the Czech Republic developed laws to permit the creation of private pension funds. It is arguable that pensions reform in the region had started even before then, in that in 1992 in the Russian Federation, President Yeltsin had issued a one-page decree permitting private pension funds. However, many of the entities which emerged in Russia bore little resemblance to what the readers of this publication might understand as a pension fund. It is only in more recent years that Russia has embarked on more meaningful pensions reform.

Back in 1993 the Hungarians and Czechs went about their reforms in very different ways. The Hungarians implemented a system of voluntary mutual benefit funds, where pension funds were created as special non-profit-making entities, either for employees of particular enterprises or on an 'open' basis. Although the law foresaw employers playing a very limited role, the outcome has been that most of the funds operating in Hungary are effectively employer-sponsored arrangements. The Hungarians also found that their desire to keep the system

non-profit making was thwarted. Many international financial institutions created non-profit-making pension funds but then arranged for those entities to subcontract asset management, administration and other functions to profit-making bodies also controlled by that institution. The Hungarian funds have proved moderately successful, in large part attributable to generous tax incentives.

The Czechs decided to exclude employers from their voluntary system. Their law provided that pension funds were to be created as joint stock companies and relatively high minimum capital requirements meant that it was impractical for all but the very largest of employers to create funds for their employees. Instead, most funds had banks, insurance companies and other financial institutions as their founding shareholders. At the time of the introduction of the new Czech system, the government of Vaclav Klaus was implacably opposed to any form of tax relief. However, it was recognised that some form of incentive mechanism would be needed and instead the government provided 'top-up' contributions in addition to those made by individuals. The way that these top-ups were constructed resulted in a large number of people being attracted to the system by the notion of a 'free gift' from the government, but few contributed meaningful amounts into their pension fund. At the end of 1998, over one-third of the working population of the Czech Republic was contributing to a pension fund, but only a small proportion of these were contributing enough to secure any sort of meaningful pension on retirement.

Even though the new Czech and Hungarian pension systems were fairly limited in their scope, they did play an important role in showing that, after

years of state domination, people would accept the idea of private pension provision. To date, the systems have also been relatively unscathed by financial scandal.

Nevertheless, it was clear that the deep problems facing the state pension systems in the region required more far-reaching reform. The inspiration for this reform came in the seminal publication of the World Bank, 'Solving the Old Age Crisis'.¹ This work argued for a mixed system of pension provision with the State taking some responsibility for providing for people's needs in their old age. However, it also argued for wide-scale private provision and reasoned that in order to achieve this, it would be necessary to introduce compulsory funded privately managed arrangements. It was a key contention of the World Bank that ensuring greater diversity of provision would minimise risks to participants from either market failure or the inability or unwillingness of governments to meet their promises.

Three-pillar pensions reforms

Spurred on by the World Bank, a large number of countries in the region have implemented or are in the process of implementing radical three-pillar pension reforms. The first pillar takes the form of reformed state social security. In a number of countries, this is now operating on a notional defined contribution basis, where benefits are much more closely linked to contributions. It is felt that this will help reduce evasion which was widespread in systems where the amounts paid in hardly had any impact on what someone would receive in old age.

The second pillar is the most noteworthy and radical element of the reforms in the region and will be the focus of most of the rest of this paper.

The second pillar is constituted by individual privately managed funded accounts with new systems drawing much of their inspiration from Latin America. The third pillar is constituted by any voluntary privately managed retirement saving arrangements.

Poland and Hungary now have three-pillar systems up and running. In the case of Poland, over 10m citizens are now members of private pension funds. This means that a little over ten years after the fall of communism, Poland has more of its citizens in private pension funds than most other European countries do. Croatia, Latvia and Bulgaria have passed legislation facilitating three-pillar systems and are now at the implementation stage. Romania has draft legislation in front of parliament and a number of other countries including Estonia, the Slovak Republic, the Ukraine and Macedonia have teams working on devising three-pillar systems. Most intriguing of all is that, in Russia, President Putin is reported to be an advocate of such reforms.

Legal basis of the second pillar

As mentioned above, the second pillar is based on compulsion. After the experiments with private pensions in the Czech Republic and Hungary, it was appreciated that only by compelling people to contribute would realistic sums be built up. Thus, most countries are compelling sections of their population to contribute, but the precise way of doing this varies from country to country. For example in Poland, at the introduction of the system in 1999, all those in work under the age of 30 were compelled to join a private fund of their choice. All those between 30 and 50 had the option of joining a second-pillar fund or staying wholly in the first pillar. In some countries, such as Hungary, the

issue has been clouded by age discrimination provisions in the constitution. This has meant adopting the provision that all those entering the labour market after the introduction of the second pillar must join a fund, but all those already in work, regardless of their age, have the choice as to whether to join a fund.

As a general rule, if an individual contributes to a private fund, a corresponding reduction is made to the amount paid into state social security. For example, in Poland the overall contribution to state social security was approximately 45 per cent before the changes were made. However, if a person contributes to a pillar 2 fund, 9 per cent of the 45 per cent is diverted to the private fund. Inevitably, this creates transitional costs in that revenues of state social security fall even though obligations are tending to increase. In large part, this shortfall is made good by the use of privatisation proceeds and by the increased demand for government bonds from the pension funds. The problem is also addressed by introducing measures to reduce state pension liabilities in future years. Nevertheless, dealing with the transitional costs is perhaps the greatest hurdle faced by any country implementing this type of reform and is perhaps the main reason why a large number of western continental European countries have not undertaken such reforms to date.

As was mentioned at the beginning, much of the inspiration for the second pillar comes from Latin America. The legal form of the pension vehicles in many countries also draws its inspiration from Latin America. With the exception of Hungary, countries which have or are implementing reforms have provided for a system whereby a pension fund is simply a pool of assets. In some countries it has legal personality but in others does

not. However, in nearly all cases, the pension fund does not employ people or enter into expenditure other than for the investment of its assets. The pension fund is controlled by a separate management company and, in most cases, the law provides for separate accounting and clearly defined flows between the pension fund and the management company. The only exception to this type of system is Hungary where the draftsmen of the law opted for a system of mutual insurance companies without there being any type of segregation. However, the Hungarian system has been criticised for its complexity and lack of transparency.

As a general rule, a person who is a member of a second-pillar fund will pay fees in two ways. To take Poland as an example, an asset management fee is deducted equal to 0.05 per cent per month. This fee is set at the same level for all funds. The competition on fees arises in relation to the deduction from contributions. A pension fund management company may make deductions from contributions and is free to determine the level. Commonly such fees are running at 8 to 10 per cent per annum. Fees can also be charged for switching, but this will be considered later.

It is very easy to articulate a convincing programme for reform. It is much more difficult to make it work in practice. Poland and Hungary both have second pillars up and running and other countries are hard on their heels. So what lessons can be learnt and what difficulties do those other countries face?

Difficulties and obstacles

Perhaps the biggest single obstacle facing a country in the region implementing second-pillar reforms is finding sources to invest the money so as to ensure security

and generate long-term growth. The markets in many countries are plagued by a lack of liquidity and a lack of transparency. Often equity markets are underdeveloped or virtually non-existent. In many cases, the only real domestic opportunity for pension funds is to invest in government paper but if this happens, claims that the system has been radically overhauled seem somewhat shallow. In effect, a second pillar investing heavily in government paper differs little from a notional defined contribution first pillar. Of course, such problems could be overcome if pension funds were permitted to invest abroad, but in most cases such opportunities are heavily restricted. In Poland, 5 per cent is permitted to be invested abroad. At the moment, Hungary permits 10 per cent to be invested abroad with this eventually rising to 30 per cent. It is not surprising that such investment is restricted in that it would probably be politically unfeasible to implement legislation which would permit such large sums of domestically raised capital to be exported at a time when capital is desperately needed in the country.

Much debate goes on as to whether foreign investment should be permitted and it really goes to the crux of the question as to whether such pension reforms are designed purely to assist social welfare or whether they have a wider role in developing domestic economies. Most governments in the region would argue that they play an important role in economic development, but if this premise is accepted it must also be accepted that pensions reform entails more than just writing a decent law and putting in place an adequate regulatory institution. Pensions reform has deep implications for the whole economy and requires institution building in other areas and, in particular, in the securities markets.

To date, fraud and misappropriation of assets has not been a major problem in Central European pension systems. Most of the funds accumulated so far are in the more developed countries of Central Europe, where the financial sector is largely dominated by Western European and American banks and insurance companies. As pension reforms spread further eastward, there must be more concern about misfeasance in that in most cases international institutions are far less involved in the financial sector.

Further concerns arise in relation to the costs of the new systems. Critics of Latin American, style second-pillar pensions argue that they are subject to high marketing costs, which are inevitably passed on to the consumer. Costs also arise in relation to frequent switching between funds. The recent experience in Poland suggests that at least the first of these concerns is justified. Last summer when pensions marketing was at its peak, there were over 400,000 people registered as sales agents in Poland. Anyone switching on their TV or radio or taking a stroll through city streets could not help but become aware of the pensions reform. While this helped ensure that the population of Poland was aware of the changes, it was achieved at a significant financial cost.

It is hoped that some of the switching problems which have occurred in Latin America will be avoided in the countries of Central Europe. In places such as Chile, it is not uncommon for people to be induced to switch from one fund to another by being offered a collateral benefit such as an immediate cash payment or an electrical device. In most Central and Eastern European countries, enacted or draft legislation makes such payments unlawful. Greater thought is also going into cooling-off periods and in preventing the selling of pension products in the workplace. Croatia has

recently enacted its pensions law and it is now contemplating a system whereby pension sales agents would be virtually eradicated. Under current proposals, an individual would not be able to enter into an agreement with a sales agent. Instead, they would have to go to an office of the Social Security Agency and sign up there. Whether this does eradicate the influence of sales agents remains to be seen. However, it will place a great strain on the social security authorities.

A further factor which can add to the costs of such systems is the sheer level of bureaucracy inherent in the administrative systems of most countries in the region. There can be a tendency on the part of many governmental authorities and regulatory agencies to place more of an emphasis on form rather than function. In one country of which the author is aware, the pension supervisory agency places an intolerable burden on pension providers, by requesting a wide range of data to be submitted on a regular basis. However, the agency does not have the personnel nor the computer capability to be able to process even a tiny fraction of the data. In Poland, entities applying for second-pillar licences often have to submit in excess of 50 thick lever arch files of documents. While it is undoubtedly the case that such institutions must be tightly regulated and it is therefore necessary to obtain extensive information, it is questionable

whether it is really appropriate to delve into as much detail as some supervisory institutions have done in recent years.

Summary

While there are undoubted teething problems in the countries of central Europe, one should not underestimate the huge strides forward which have been taken in the countries of Central and Eastern Europe. In many areas, these countries have, while undertaking other radical reforms, managed to overhaul their system of pensions provision comprehensively. Such shock therapy may be politically unpalatable in many countries of Western Europe, but few would doubt that many countries there will also need to find mechanisms whereby they enable much greater private sector provision.

The challenge now facing the countries of Central and Eastern Europe is to ensure that their pension systems avoid excessive bureaucracy, while at the same time not falling prey to fraud. Countries also need to develop their capital markets and related legislation in order to ensure that funds have appropriate investment opportunities and that future generations of pensioners can enjoy adequate pensions on retirement.

Reference

- 1 World Bank Research Publications, (1994) 'Averting the Old Age Crisis', Oxford University Press/World Bank, USA.