New Realities of Pension Policy in Central Europe

Anita M. Schwarz
Lead Economist
Human Development Group
Europe and Central Asia Region
World Bank

June 2011
The Europe and Central Asia region’s countries inherited pension systems that were not fiscally sustainable given the transition to market economies. All 30 countries undertook some form of pension reform, some more successful than others, and each chose a configuration that for political, historical, ideological and institutional reasons seemed appropriate for its own characteristics, resulting in 30 different pension system configurations. In the boom years prior to the financial crisis, policymakers began to reverse elements of the reforms, particularly those which had most severely constrained pension spending. As the financial crisis hit, this expanded pension spending increased the fiscal pressures the countries were facing which led to another round of reforms. The responses to the financial crisis included some reversals of the original pension reforms, particularly in the large central European countries, and the Baltics. This note will look at (i) the original pension reforms, (ii) policy outcomes and changes during the boom years, (iii) changes in external constraints, (iv) policy responses to the financial crisis, and (v) risks associated with the policy reversals.

I. The Original Pension Reforms

Pension reform in the transition countries in the 1990’s was driven initially by stark financial imbalances. Expenditures were high because large percentages of the elderly had pension rights and were receiving pensions, as high as 99% of the elderly in the former Soviet Union countries and somewhat lower, but still high percentages in central Europe. The transition process itself resulted in significant unemployment particularly among older workers whose skills no longer matched what employers needed, leading them to take advantage of the generous early retirement provisions offered or the easily obtained disability benefits. On the revenue side, the same high unemployment reduced pension contributions exacerbated by the inappropriateness of the existing enforcement mechanisms to a market economy. As a result, workers began to work in informal labor markets where contributions were not paid, resulting in even less revenue going to the pension funds.

The initial response to the revenue shortfall in several countries was to raise contribution rates to increase revenues, but as it became clear that raising rates did not necessarily raise revenues, countries took the opposite tack and began reducing contribution rates in an effort to reduce informality. This was accompanied by a host of expenditure-reducing measures, such as raising retirement ages, reducing early retirement, tightening disability requirements, lengthening the averaging period for the wages used to calculate pensions, lowering accrual rates, and moving indexation toward inflation indexation.

In addition to these measures, many countries changed the overall design for benefit accumulation and calculation. Public pension systems tend to have two main objectives: (i) alleviation of poverty in old age and (ii) providing a mechanism to replace income which can no longer be earned in old age. There is a trade-off between these two objectives since a focus on poverty alleviation will not result in significant replacement income for middle and upper income individuals, while a focus solely on income replacement can result in substantial poverty among the elderly, particularly among the lower income and those with irregular work histories. Internationally, countries make starkly different choices, from a heavy poverty alleviation focus in countries like Australia and New Zealand, to the opposite focus on income replacement in countries like Austria. A focus on income replacement for the public pension system also does
not preclude poverty alleviation through a separate instrument like targeted social assistance. The transition countries, like other countries, made choices along the spectrum of poverty alleviation and income replacement. Some, like Georgia, Kazakstan, and Kosovo chose to focus public resources on poverty alleviation. Others like Poland, Hungary, and Slovak Republic chose to tie benefits tightly to earnings and focus on providing income replacement. Some of these countries adopted variants of conventional defined benefit schemes such as the point system or notional accounts which effectively tie future benefits to contributions paid. Still others designed their systems to focus on income replacement, but in response to concerns about poverty among the elderly and political pressures, raised minimum pensions more than higher pensions, leading to a compression of pension benefits more similar to the outcome of a poverty focused benefit even though the design remains income replacement focused. The greater focus on income replacement and tying contributions to benefits in this region can be partly attributed to efforts to provide incentives for formalization of labor markets and partly to a backlash against the previous systems where individual effort did not lead to substantially different individual outcomes.

Looking ahead, many countries also recognized that with a rapidly aging population, there were limits on what the public system would be able to provide in benefits in the future. As a result, fourteen countries in the region set up mandatory savings systems, or second pillar systems, for workers that would allow future retirees to supplement their lower public pensions with additional income from the savings accounts. In addition, all countries put in place at least a rough legal framework to govern voluntary savings. In most countries, however, the accumulation of voluntary savings has been relatively minimal. This outcome is not particularly surprising given that contribution rates in these countries for pensions alone are typically above 20% of wage, frequently with additional contributions for health insurance, unemployment insurance, sickness and maternity, and work injury. There is just not sufficient budgetary space for employers or employees to contribute even more on a voluntary basis and while pensions for the most part have remained reasonably adequate, there has been little demand for supplementary pensions. One of the few exceptions has been the Czech Republic where the government maintained a highly redistributive system in the public pillar and then chose to match contributions to voluntary savings accounts, but only up to a fairly low level. The outcome has been a large number of voluntary accounts, but with relatively few assets with most individuals only contributing up to the amount of the match. A table showing the pension system designs of the countries can be found in the Appendix.

II. Policy Outcomes During the Boom Years

After an initial period of austerity in the 1990’s, many of the economies experienced substantial growth during the first 7 years of the 21st century. Given the high level of overall growth which was reflected in an extraordinary growth in real wages, countries often loosened many of the expenditure-reducing policies they had put in place earlier. While the retirement age reforms which had been put in place, the discouragement of early retirement, and the tightening of the disability provisions remained in place, the indexation reforms were frequently loosened with large increases for existing pensioners.
Some of the increases were a necessary response to the extraordinary high real wage growth experienced during the boom years, driven both by recovery from the initial shock of transition to market economies and by the convergence process for those countries joining the European Union. Pensioners felt that in the 1990’s when the economies had contracted, they, like wage earners and everyone else in the economy, had seen their real incomes fall. But in the boom years while wage earners enjoyed extraordinary real wage growth, in some countries as much as 20% real wage growth for multiple consecutive years, the legislated indexation would have kept pensioners’ incomes growing far less, resulting in a sharp drop in the average pension to average wage ratio. The discrepancy was exacerbated by two additional factors. First, the older pensioners’ pensions were based on the compressed and often lower wages earned in the pre-transition years and the immediate years post-transition, making them in most cases lower than if they had been based on wage history similar to that in non-transition countries. Second, the use of the pension system as unemployment insurance during the immediate post-transition period through lax disability and early retirement eligibility resulted in retirees receiving pensions for an extended period of time and the cumulative effect of lower than wage growth indexation over a long period of time with high real wage growth, resulted in a relative lowering of pensions relative to wages. Finally, it is worth mentioning that the pre-transition average pension to average wage ratios were simply not sustainable, but to the elderly who were forced to accept so many changes and had endured the austerity of the 1990’s, returning to the more-generous past levels of pensions during boom times was an important priority.

As a result of the political pressures coming from the drop in average pension to average wage ratios, pension spending increased quite sharply in many countries just prior to the crisis. The mechanisms for raising pension spending included pension increases above what was legislated by law, adding supplementary benefits for the older retired, adding a thirteenth pension, and recalculating the benefits of the already retired. Figure 1 shows the old age pension spending per elderly person (defined as those 65 and older) compared to GDP per capita for a select number of countries. Hungarian pension spending per elderly person was higher than GDP per capita throughout the pre-crisis period, while the other countries largely experienced increases in the 2-3 years pre-crisis.

Second Pillar Outcomes

The countries which introduced second pillars largely chose to maintain or even reduce contribution rates overall and to divide the overall contribution rate so that one part went to the public system or first pillar and the remainder went to the second pillar. The decision to split the overall contribution rate instead of adding a second pillar contribution rate to the existing contribution system was largely based on the already high level of contributions and concerns about adversely affecting labor competitiveness with even higher contributions. But when part of the first pillar contribution rate is now saved in individual accounts, revenues to the public system fall. Expenditures from the public system initially remain the same since the retirees and soon to be retired receive the same pensions as before. In the future, expenditures from the public system will fall as those whose contributions only partially went to the first pillar receive only partial pensions from the first pillar. Figure 2 shows the expected trajectory of deficits in a typical central European country that chose to adopt a second pillar. While the introduction of a second pillar widened the fiscal deficit of the pension system for almost 40 years, it will provide
considerable savings during the peak of the demographic crisis. There were also some privatization proceeds which helped alleviate the widened deficit in the early days of the reforms, and reformers planned to enact further expenditure-reducing reforms in the public system once the public had become accustomed to the reforms initially enacted. Further reforms would have moved the dashed line shown in Figure 2 to the right, narrowing the deficit which needed to be financed. However, as noted above, the countries moved in the opposite direction, enhancing public benefits, moving the dashed line further to the left and widening rather than narrowing the deficit to be financed.

Figure 1: Comparison of Pension Spending per Elderly Person to GDP per capita
In terms of second pillar performance, results have generally been favorable, but have varied across countries. The initial introduction of the second pillar accounts generated significant enthusiasm in the countries with many more workers choosing to join the second pillar than had been expected in countries where choice was provided. The popularity of the second pillar added to the immediate fiscal costs related to the introduction of the second pillar since it increased the percentage of contribution revenues no longer available to finance first pillar pensions, but slightly shortened the period before substantial fiscal savings would begin to appear. The second pillar has generally remained popular. A survey taken in Latvia suggests that the government’s reduction of contribution rates to the second pillar as a response to the fiscal crisis was not positively perceived, as shown in Figure 3. In Poland and other countries, there has been an active debate by proponents of the second pillar. On the other hand, in Hungary, the second pillar was virtually nationalized with little public reaction.

Figure 2: Projected deficits for a typical central European country which introduced a funded or second pillar

![Projected Pension System Deficits](image)

- Projected Pension System Deficits
- (1.0%)
- (2.0%)
- (3.0%)
- (4.0%)
- (5.0%)
- (6.0%)
- (7.0%)
- 2007
- 2011
- 2015
- 2019
- 2023
- 2027
- 2031
- 2035
- 2039
- 2043
- 2047
- 2051
- 2055
- 2059
- 2063
- 2067
- 2071
- 2075
- % of GDP
- Without funded pillar
- With funded pillar
Rates of return for the most part have been positive, but again there is variation across the countries. Figure 4 shows the real rates of return for a number of the countries from the inception of the second pillar reforms until 2007. It should be noted that since the reforms took place at various times in the different countries, the averaging period is different in each of the countries. The left hand panel of Figure 4 shows that while most of the second pillars have generated positive real rates of return, the Slovak real rate of return was quite small, and Latvia generated negative real rates of return until 2007. The right hand panel shows the real rates of return in 2008-10. The financial crisis clearly resulted in negative rates of return in all the countries, but 2009 and 2010 showed positive returns in most of the countries. The Slovak Republic, seemed to show a smaller negative return than the others in the primary crisis year, and while it has improved since, the return did not become positive through 2010.

Figure 3: Latvian opinions on reduction of second pillar contribution rates
The experience with the second pillar also led to some somewhat unexpected outcomes and policy lessons in these countries. As had been experienced in the Latin American context, management of the pension funds was costlier than expected in some countries. Consolidation of collection and record-keeping did not necessarily reduce costs as had been expected, in countries like Croatia. On the other hand, imposing very tight caps on administrative costs, as in Slovak Republic, resulted in overly conservative investment portfolios which led to lower rates of returns for participants. There is a fine line between imposing a limit on administrative costs which can discourage excessive marketing on the parts of pension fund managers, while providing sufficient incentives for prudent risk-taking that will generate higher rates of return. Subsequent reforms in many of the countries have focused on trying to find the appropriate balance.

Another expectation had been that individuals would actively participate in choosing among portfolios where multiple portfolios were allowed and between pension fund managers based on administrative costs and investment strategies. The experience has been that many individuals have not made active choices and even once a choice has been made or a pension fund assigned to them, inertia has tended to prevail with individuals not making active choices. Some of this can be attributed to limited financial literacy among the population at large, but this
same inertia is evident in countries where financial literacy would be expected to be high and even within subsets of the population where financial literacy is the highest. This outcome points to the continued importance of both providing financial education and of designing default options, like life-cycle portfolios, which will provide favorable returns for the average individual, in the absence of pro-active choice by individuals.

A third outcome, which was not wholly unexpected, is that countries that chose to finance the introduction of a second pillar largely by issuing debt rather than by reducing expenditure within and outside the pension system or by raising revenues found themselves with unsustainable levels of government debt. At the time of the initial reforms, policymakers and technical experts had even suggested that debt financing of the second pillar introduction might be superior to expenditure reductions since it spread the cost of this introduction across multiple generations rather than forcing one or two generations to bear the brunt of the cost while future generations benefit. Heavy reliance on debt financing also ran into national debt ceilings as well as ceilings agreed under the European Stability and Growth Pact, which is especially important for countries who are trying to join the Eurozone. Looking back at Figure 1, it is not surprising that the countries which undertook the greatest amount of expenditure expansion prior to the financial crisis felt the most constrained by the increased amount of debt they undertook to finance the second pillar.

Finally, a big selling point of the second pillar at its inception had been that while government policy controls can change public pension policy regarding first pillars, there was some risk diversification and security for individuals with second pillars because the accounts were the property of individuals and not subject to confiscation. Prior to the financial crisis, there was little government interference, but the experience since the financial crisis, described in Section IV, suggests that second pillars are not immune to government interference, particularly when governments face economic and financial crises and unpalatable choices.

III. Impact of Changes in Factors External to the Pension System

In addition to the direct policy changes in first and second pillar pension systems, a number of external factors had an impact on the outcomes in both pillars. The first of these is the resilience of informal labor markets. Typically middle and lower income countries have a significant part of economic activity taking place in informal markets. The informal activity evolves to take advantage of lower informal labor costs, lower taxable output, and less burdensome regulation, as well as weak enforcement powers, but also evolves from limits in individual’s trust in the government and its governance. Pre-transition, the Europe and Central Asian countries had large formal markets, since much of the economic activity was state-dominated and consisted of large enterprises which were subject to all the regulations, taxation, and contributions imposed by the state. As a result, as Figure 5 shows, most of the countries, pre-transition, had much higher participation or coverage in the social security system than similar middle income countries in other regions of the world. The belief at transition had been that more enforcement effort could result in a rapid return to the high coverage rates of the past, but the breakup of the large state-owned enterprises resulted in a proliferation of many, small private-sector establishments which responded to the incentives provided by the informal markets and were much harder to track. It was also believed that tying benefits to contributions and focusing on income replacement by adding a second pillar, but also by redesigning the
public pension system would result in increased participation and coverage. But as a result of the change in market structure, the coverage rates in the region have tended to converge around rates appropriate to their income levels with higher coverage in the higher income countries and lower coverage in the lower income countries. The impact of this change on the pension systems is that while large percentages of the elderly continue receiving pensions, contribution revenues have only partially rebounded despite healthy pre-crisis growth rates, and the informal labor markets, rather than being a temporary phenomenon, are more likely to be a permanent phenomenon, only gradually disappearing as the countries become richer.

![Relationship between Per Capita Income and Contributor Coverage](image)

**Figure 5: Middle income countries tend to have lower coverage rates than higher income countries**

A second factor which has worsened pension policy outcomes has been continued out-migration of the working age population to western Europe and other high income countries. Immediately post-transition, the drop in income and employment opportunities encouraged individuals to emigrate in search of better incomes. While some returned during the boom years, a significant number continued to remain abroad and were joined by new emigrants. The pace of emigration accelerated once again during the financial crisis. Figure 6 shows the number of 30-35 year olds, individuals in peak working years, in central Europe in 2010 compared to the number of children born in these countries between 1975 and 1980. While some children born in the late 1970’s may have succumbed to child mortality, the bulk of the missing, more than 15% in countries like Bulgaria, Lithuania, and Estonia are people who emigrated. By contrast, Denmark and Sweden currently have substantially larger populations of 30-35 year olds than were born there in the late 1970’s. This emigration out of central and eastern Europe affects contribution revenue used to finance the pension system. Not only has there been a drop of coverage among the labor force, but the labor force itself has shrunk due to the emigration. And
while the initial assumptions had been that once the countries stabilized and began to grow the emigrants would return, emigration is now expected to continue in the future as western Europe faces its own shrinking working age population and pulls in workers from central and eastern Europe.

A third factor, the decline in birth rate, suggests that pension systems will continue to face fiscal constraints in the medium and long term. While the decline in birth rates in high income countries is well documented and contributes to the expected aging of the population, the decline in birth rates in the transition countries of central Europe has been much sharper and has continued over the 20 years since the transition process began. Figure 7 shows the number of children under the age of 5 in the years since transition, as compared to in 1990. This sharp decline in fertility suggests that even if birth rates per woman of reproductive age were to rise or return to their pre-1990 levels, the reduced number of women reaching reproductive age, coming from the significantly smaller cohorts born between 1990 and 2010, would continue to result in a smaller number of total births for the next couple of generations and reduced labor supply for at least another 40 or 50 years.

The combination of the drop in fertility and the increased emigration is a sharp expected decline in the working age population which will have a direct impact on the expected contribution revenues which can be used to finance the pension system. Figure 8 shows the working age population in 2050 compared to the working age population existing in 2010. Countries like Bulgaria, Bosnia, Belarus, Ukraine, and Moldova are expected to lose almost 40% of their working age population. Increased rates of immigration may help reduce this somewhat,

Figure 6: Emigration substantially reduces the working age population

<table>
<thead>
<tr>
<th>Country</th>
<th>2010</th>
<th>2050</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td>Lithuania</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td>Estonia</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td>Romania</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td>Latvia</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td>Poland</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td>Hungary</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td>Turkey</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td>Denmark</td>
<td>100%</td>
<td>60%</td>
</tr>
<tr>
<td>Sweden</td>
<td>100%</td>
<td>60%</td>
</tr>
</tbody>
</table>
but the larger the number of immigrants needed, the more difficult it is to assimilate them within the current population.

![Number of Children under 5 compared to 1990](image)

**Figure 7:** Fertility rates dropped by a third since 1990

![Working age population is expected to fall 35-40% in some countries by 2050](image)

**Figure 8:** Working age population is expected to fall 35-40% in some countries by 2050

Combining the sharp decline in contribution revenues with the growing expenditures associated with an aging population suggests that the pension systems in this region are not just in a temporary crisis due to the transition, but will continue to face a prolonged and deepening future crisis. Figure 9 shows the expected increase in the percentage of the population over the
age of 65 in each of the countries. In most cases, countries expect to see a doubling or tripling of the percentage of population over the age of 65, with the larger increases for countries which are younger today and the smaller increases for countries with populations that are already relatively old.

A final external factor that affected policy outcomes, particularly for countries in the Eurozone and Eurozone aspirants, is the treatment of the fiscal costs associated with the introduction of the second pillar. In the initial years of the reforms, the second pillar countries had argued that they were taking on additional fiscal deficits in the short run in order to run smaller deficits in the longer run. EUROSTAT, the European Union Statistics Agency, had ruled that for a limited period of time, all mandated contribution revenue, whether going to the first or second pillar, could be counted as government revenue. This ruling meant that while the introduction of a second pillar with the contribution revenue split between the pillars typically creates a fiscal deficit in the pension system because all the contribution revenue is no longer available to finance the same public pension expenditures in the short run, as shown in Figure 2, this deficit would not show up in the aggregate deficit numbers of the second pillar countries. The ruling made it significantly easier for these countries to meet the deficit targets of the Stability and Growth Pact. When the initial time period expired, it was not renewed. After repeated requests from the involved governments, the European Council agreed that second pillar countries could use a slightly larger deficit target, but for a limited duration, while a longer term solution to this issue is devised. Given the limited extent of this ruling and the uncertainty associated with the limited duration, Eurozone aspirants began to reconsider the issue of the second pillar.

IV. The Impact of the Financial Crisis

Although the financial crisis had its origins in the financial sector and the second pillar pension funds did have negative rates of return during the prime year of the crisis, from the
perspective of the pension system, the primary impact of the crisis was not through the second pillar pension funds. In most of the countries, very few people, if any, were retiring with second pillar pension funds in 2008. The current second pillar countries introduced the pension funds between 1998 and 2008. Typically older workers were discouraged or even prohibited from joining the second pillar since the likelihood of their being able to accumulate significant funds in the second pillar, given administrative fees, in the few years they had before retirement was limited. Unlike the Latin American countries which enacted similar reforms, in this region, the savings accounts were only used to provide old age benefits with disability and survivors’ insurance continuing to be provided through the public system only. As a result, few people faced a loss of second pillar pension from the financial crisis. If a similar financial crisis occurs 15 years in the future, there could possibly be a much larger impact through the second pillar funds.

However, this does not suggest that the pension systems were unaffected. The primary impact came through the first pillar systems rather than the second. The financial crisis had an almost immediate impact on the level of economic activity in the region. As activity slowed, unemployment rates rose. As fewer people were employed, contribution revenue to both pillars declined. Since in the first pillar, contribution revenue finances current pensions paid by the government, a large deficit appeared in the first pillar accounts, irrespective of whether the country had a second pillar or not. Wage growth slowed and in some cases and for some sectors, wages even fell, again adversely affecting contribution revenue. While several countries tried, few countries succeeded in lowering benefit levels. Some were able to freeze pensions in nominal terms, but since average wages tended to fall, the average pension benefit actually rose relative to average wage. Finally, as is typically the case, employers and workers tried to ease the pain of unemployment by increasing early retirement and disability eligibility, resulting in some increase in beneficiaries in some countries. The overall impact with benefit levels rising or frozen and the number of beneficiaries rising was that pension expenditures tended to rise. With pension expenditures rising and contribution revenues falling, whatever deficits existed in the systems to begin with were magnified. Deficits in public pension systems are typically guaranteed by the state. As the pension systems began to run larger deficits, these were transferred to the overall government budget. But the drop in economic activity had an equally depressing impact on revenues going to the overall budget. Consequently, the overall budgets were already facing higher than expected deficits even before the now higher pension deficits were added in.

Given the situation, governments responded as best they could. Romania and Russia both raised contribution rates. Serbia froze pensions in 2009 and 2010. Hungary abolished the 13th pension and moved to inflation indexation of existing pensions unless GDP growth exceeded 3% in a given year. Croatia suspended indexation in 2010. Latvia initially cut pensions 10%, but this was found unconstitutional and the difference was returned to pensioners. Macedonia reduced indexation and Ukraine froze pensions in 2009. Romania legislated a move from wage indexation to inflation indexation after freezing pensions in 2010. Lithuania cut old age pensions between 3.3 and 12.4% in 2009 with a plan for restoration of these cuts in the future. Hungary also raised the retirement age from 62 to 65 between 2009 and 2012. Poland eliminated various early retirement schemes. Hungary increased penalties for early retirement and introduced bonuses for delayed retirement. Latvia reduced early retirement pensions from 80% of normal pensions to 50% and eliminated early retirement from 2012. This is not necessarily a
comprehensive list of all the measures taken, but provides at least a flavor of the often drastic measures that countries undertook.

Despite the desperate measures, in some cases the countries were still facing deficits that they could not finance. This was particularly painful for Eurozone aspirants who felt in late 2008 and early 2009 that the best protection for their economies against the financial crisis would be being part of the Eurozone. Against this backdrop, for those countries that had a second pillar, diverting second pillar contributions back to cover first pillar deficits, even temporarily, seemed like a painless way of generating further resources. Estonia fully diverted second pillar contributions which were 4 percentage points from the overall contribution rate to help finance first pillar pensions in 2009; it then allowed individuals to contribute above the first pillar contribution to their second pillar accounts in 2010 (Estonia always had a higher overall contribution rate for those who contributed to the second pillar); and it began to restore the second pillar contribution rate in 2011, with full restoration by 2012. Estonia intends on providing a catch-up period in 2014-17 which will put a higher percentage of the overall contribution into the second pillar accounts as a way of making up for the lower amounts which were contributed to the second pillar during the crisis. Estonia successfully joined the Eurozone on January 1, 2011.

Estonia’s Baltic neighbors, Lithuania and Latvia, started with a similar approach. Lithuania lowered its second pillar contribution rate from 5.5% to 2% in 2009 and 2010 with the intention of returning to 5.5% in 2011 and then allowing 6% between 2012 and 2014 to again allow a catch-up period. But the return to the normal second pillar contribution rate has been postponed. In Latvia the second pillar contribution rate had been scheduled to rise from 8% of wage to 10% in 2010. In 2009 the rate was reduced from 8% to 2%, with the intention of raising it in 2010 to 4% and then fixing it at 6% from 2011, but again the restoration has been postponed. Romania had just introduced its second pillar in June 2008 with a 2% contribution scheduled to rise 0.5 percentage point each year until it reached 6%. The 2009 increase was suspended, with the contribution rate fixed at 2%, but beginning in 2010, the rate increased to 2.5% and is continuing with the 0.5 percentage point annual increase.

Poland, after having survived the financial crisis with positive growth throughout, became concerned about breaching its national debt limits and breaching the limits imposed by the Stability and Growth Pact. In 2011, well after the worst of the crisis had subsided, Poland reduced second pillar contribution rates from 7.3% to 2.3%, with a possible rise to 3.5% beginning in 2017. Hungary went one step further and offered to return all workers to the public pension system in exchange for their relinquishing their second pillar accounts to the government. Those who chose to keep their second pillar accounts would no longer earn first pillar benefits beginning in 2012. These actions essentially resulted in a nationalization of the private pension system.

It is worth noting that of the 14 countries in the region with second pillars, only the five with immediate aspirations toward Eurozone entry chose to engage in this form of second pillar reversal. Romania, for whom the euro is a bit further away only temporarily postponed an increase. Estonia is back to the second pillar after its successful Eurozone entry. The Slovak Republic which is a Eurozone member did not reverse course. But Hungary, Poland, Lithuania, and Latvia might have been influenced by the positive impact a reversal could have on their entry into the eurozone.
V. Are Reversals a Good Idea?

Clearly the more permanent second pillar reversals were politically easier for governments to undertake than other expenditure-reducing measures. In all of these countries, the World Bank, the IMF, the European Commission, external consultants, and domestic policymakers and think tanks prepared reports on expenditure-reducing measures, yet the governments chose something that was not on the list of recommendations over all those that were recommended. Were the reversals better choices than the alternatives? The future will have to provide the answer to that question. They were certainly easier than some of the alternatives, but whether they have as much of a long run positive impact on fiscal adjustment remains to be seen. Joining the Eurozone certainly can have a strong positive impact on these economies. And that might be seen as sufficient to outweigh any negative impact from the reversals.

However, a number of concerns come to mind. The pension fund business is a fixed cost per account business. The bulk of the administrative costs come from opening an account and doing the record-keeping, which is the same whether the account gets contributions of 6% of wage or 2% of wage. While pension funds can look for efficiencies, the same fixed costs now need to be paid out of lower interest earnings, lowering the net rate of return to account holders. Public support for second pillars may drop off as people see a substantial part of their now-meager contributions disappearing in administrative costs. If governments cap the administrative costs too tightly, the pension funds may exit the business. One concern is that the lower second pillar contribution rates are only a first step toward a Hungarian style shutting down of the second pillar. The uncertainty that this concern brings negatively affects the provision of old age security for today’s workers. In some sense if countries are eventually going to end up with the Hungarian approach, it might be better to go there immediately rather than prolong the uncertainty.

A more pressing concern comes to mind when the financial crisis is put in the perspective of the coming demographic crisis. Figure 10 shows the impact of the 2008-10 financial crisis on the pension system relative to the impact of the coming demographic crisis. The financial crisis that has caused so much pain and misery in this region and so many difficult choices looks like a minor blip compared to the coming demographic crisis. Now that some of the governments are eliminating or reducing the potential impact of the second pillar as a possible coping mechanism, they are left with what might be in the longer run even less palatable choices. They can raise retirement ages to 70 or 75; they could reduce average benefits by about 40%; or they could actively encourage immigration from wherever immigrants are available. Since reducing the second pillar results in larger adjustments required in the limited remaining parameters in the future, it would be useful to have a public discussion of the long run strategy and gauge its acceptability before decisions are made on reversing the second pillar.
Given sure knowledge of the coming demographic crisis, exacerbated by the growth of informal labor markets, emigration, and sharp fertility declines, governments need to think hard about what measures they will take to provide old age security in the future. The abrupt policy changes that were witnessed during the financial crisis lead to insecurity rather than security and call into question the stability of government policymaking. The issues go beyond pension policy into all other areas of policymaking. If the government can change the rules of the game so drastically in one sector, what is to prevent it from doing the same in other sectors? While the financial crisis of 2008-10 was unexpected certainly in terms of its magnitude and impact, governments responded also in unexpected ways. The demographic crisis is certain; it is crucial that governments think through the potential solutions required to avoid abrupt changes in policy, prepare the public for the policy measures they intend to enact, and then stay the course.
<table>
<thead>
<tr>
<th>Country</th>
<th>Public Pension System</th>
<th>Private Pension System</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>Conventional Defined Benefit</td>
<td></td>
</tr>
<tr>
<td>Armenia</td>
<td>Conventional Defined Benefit</td>
<td>Mandatory legislated to begin in 2014</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>Notional account</td>
<td></td>
</tr>
<tr>
<td>Belarus</td>
<td>Conventional Defined Benefit</td>
<td></td>
</tr>
</tbody>
</table>
| Bosnia & Herzegovina     | Conventional Defined Benefit; Republika Srpska is beginning a point system in 2012 | Date: January 2002  
Mandatory for: <42  
Contribution Rate: 5% of wage |
| Bulgaria                 | Conventional Defined Benefit                         | Date: January 2002  
Mandated for: <42  
Contribution Rate: 5% of wage |
| Croatia                  | Point System                                         | Draft law to introduce mandatory second pillar  |
| Czech Republic           | Conventional Defined Benefit                         |                                                 |
| Estonia                  | Conventional Defined Benefit                         | Date: July 2002  
Voluntary election but requires additional 2% contribution  
Contribution Rate: 4% from social contribution plus additional 2%  
*During and post-crisis: 2nd pillar contribution rate suspended in 2009; individual contribution of 2% (additional amount) allowed in 2010; 2% + 2% in 2011, with a return to the previous 4% + 2% in 2012; catch-up period planned for 2014-17 with rate at 0%-2%* |
| FYR Macedonia            | Conventional Defined Benefit                         | Date: January 2006  
Mandatory for new entrants  
Contribution Rate: 7.12% of wage |
| Georgia                  | Universal flat pension for all >65M/60F              |                                                 |
| Hungary                  | Conventional DB                                      | Date: January 1998  
Mandatory for new entrants; voluntary election for others;  
Contribution Rate: 8% of wage  
Nationalized in 2011 |
| Kazakhstan               | Universal flat pension for all >65                  | Date: January 1998  
Mandatory for all workers  
Contribution Rate: 10% of wage |
| Kosovo                   | Universal flat pension for all >65                  | Date: January 2002  
Mandatory for <55  
Contribution Rate: 10% of wage |
| Kyrgyz Republic          | Notional Account                                     | Date: 2010  
Contribution Rate: 2% of wage |
| Latvia                   | Notional Account                                     | Date: July 2001  
Mandatory for <30, voluntary choice for 30-50  
Contribution Rate: started at 4%, grew to 8% pre-crisis  
*During and post-crisis: rate fell to 2% and has been maintained at this level* |
| Lithuania                | Conventional Defined Benefit                         | Date: January 2004  
Voluntary choice for all workers  
Contribution Rate: 5.5% pre-crisis  
*During and post-crisis: rate fell to 2% and has been maintained at this level* |
| Moldova                  | Conventional Defined Benefit                         |                                                 |
| Montenegro               | Point System                                         |                                                 |
| Poland                   | Notional Account                                     | Date: January 1999  
Mandatory for <30; voluntary choice for 30-50  
Contribution Rate: 7.3% of wage  
*Post-crisis (2011): rate falls to 2.3% of wage with the option of rising to 3.5% again in 2017* |
| Romania                  | Point System                                         | Date: January 2008  
Mandatory for <35; voluntary choice for 36-45  
Contribution Rate: 2% of wage growing to 6% at rate of 0.5% increase per year  
*During crisis: 2009 rate increase postponed for 1 year, but now continuing increase in rate* |
| Russian Federation       | Notional Account                                     | Date: January 2002  
Mandatory for: <50  
Contribution Rate: 6% of wage |
| Serbia                   | Point System                                         |                                                 |
| Slovak Republic          | Point System                                         | Date: January 2005  
Voluntary choice for existing workers and new entrants  
Contribution Rate: 9% of wage |
| Slovenia                 | Conventional Defined Benefit                         |                                                 |
| Tajikistan               | Conventional Defined Benefit                         |                                                 |
| Turkey                   | Conventional Defined Benefit                         |                                                 |
| Turkmenistan             | Conventional Defined Benefit                         |                                                 |
| Ukraine                  | Conventional Defined Benefit                         | Partially legislated                             |
| Uzbekistan               | Conventional Defined Benefit                         |                                                 |
Selected References


