

# Pension reform overview

**Ryszard Petru**

**Chief Economist**

**Bank BPH**

# Common features of pension schemes before transition

- PAYG defined benefit schemes
- wide range of sector privileges
- low effective retirement age
- state monopoly
- relatively high payroll taxes

# Common transition features

- lower contribution base due to unemployment
- pensions treated as the safety net
- evasion
- rising dependency ratio
- growing pension expenditures

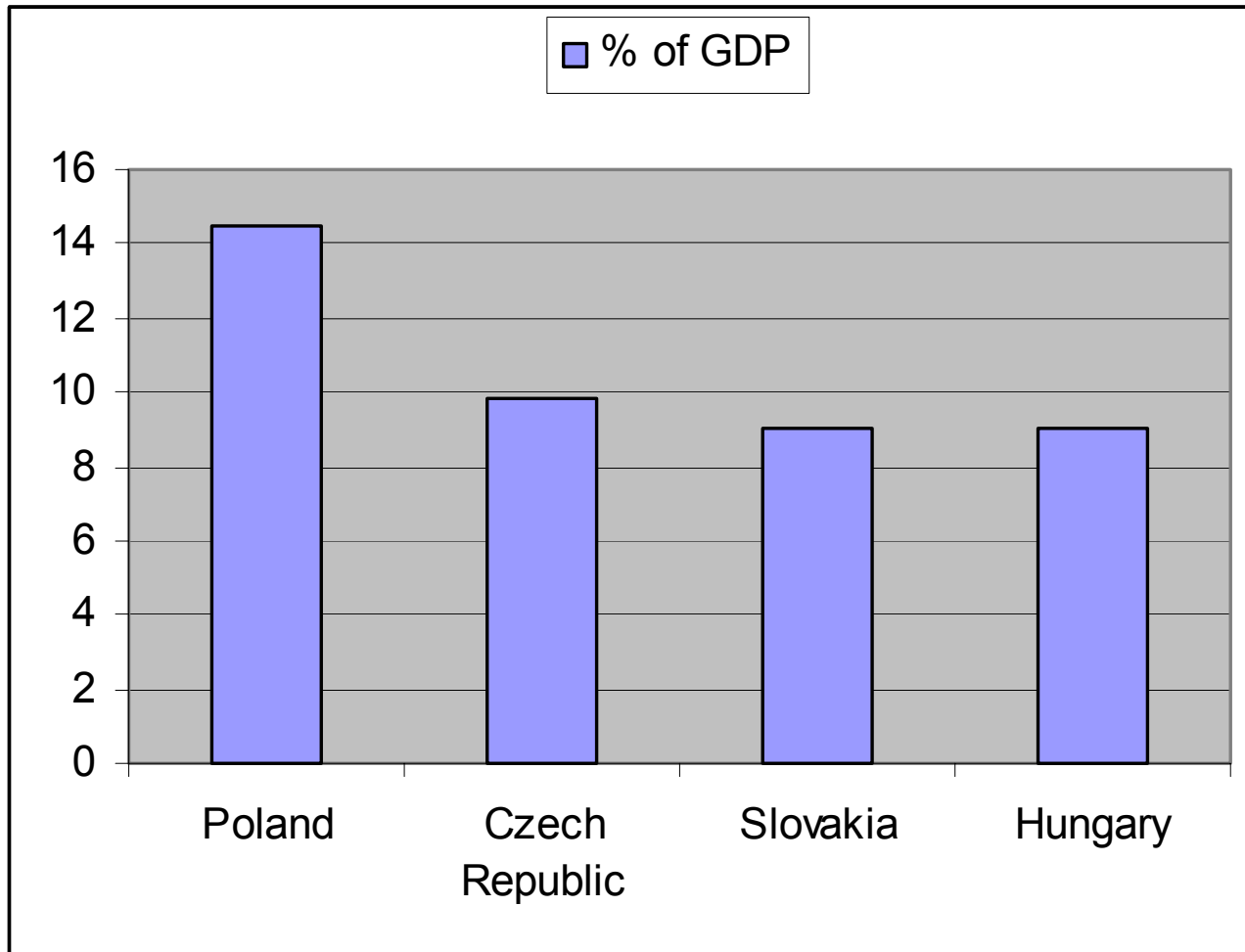
# Main goals of reform efforts

- to arrest growing expenditures (through rising retirement age, changing indexation formula)
- creating incentives to pay contributions (establishing a link between contributions and pensions)
- involving private sector
- phasing out privileges

# But different approaches

- Gradual approach (Czech Republic)
- Deep but partial reform (Hungary)
- Comprehensive reforms (Poland, Slovakia)

# Pension expenditures in 2001



# Hungary: 1998

- Three pillar system
- PAYG reform
- Introduction of II pillar
- III pillar voluntary (in place since 1994)

# Hungary pension reform

	“Old” PAYG	“Reformed” PAYG	New system	
			First pillar	Second pillar
Contribution rate	30%	30%	24-23-22%	6-7-8%
Annual accrual rates	Non-linear, equivalent to 2% of net wage.	Linear, 1,65% of gross wage.	Linear, 1,22% of gross wage	n.a.
Pension base	Gradual increase to lifetime earnings	Gradual increase to lifetime earnings	Gradual increase to lifetime earnings	-
Redistribution factor	Yes	No	No	-
Normal retirement age	60 (men);55(women)	62 (both)	62 (both)	62 (both)
Early retirements rules	Low penalty rates and minimum service years for early retirement	Higher penalty rates and minimum service years for early retirement	Higher penalty rates and minimum service years for early retirement	-
Indexation of pensions	Backward net wage indexation	Contemporaneous Swiss	Contemporaneous Swiss	-

# Hungary 1st pillar reform

- Rising retirement age
- Rising number of years for early retirement (to 40)
- Penalties for early retirement and reward for late retirement
- Swiss indexation formula
- Creating a link between contribution and benefits (to be effective from 2013)
- Total contribution 30 percent

# Hungary 2<sup>nd</sup> pillar

- Privately managed
- 2.3 milion participants (58% of eligible)
- Contribution rate 8% (initially 6%)
- Investment limits (50% equities, 50% investment funds, 5% in real estate)
- Mimimum rate of return not lower than yield from long term gov bonds (otherwise the gap to be financed from reserve fund)
- 30% investent limit on foreign investments

# Hungary. Unfinished agenda

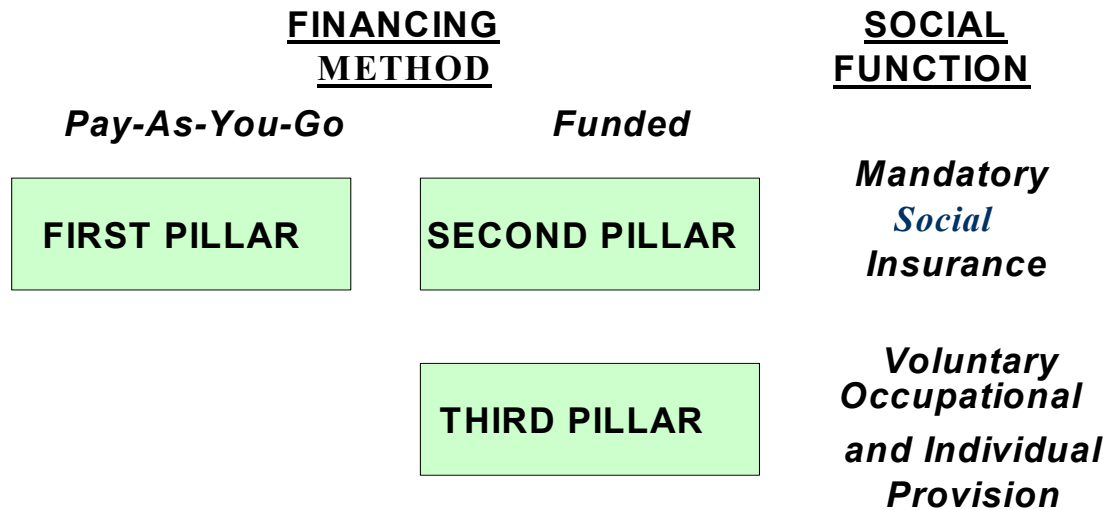
- Subject to political manipulation
- Low contribution base due to low employment
- Does not respond to demographic challenge, current old dependency ratio at 35 percent, will reach 50 percent in the mid of the century

# Poland:1999

- Three pillar system
- NDC in the 1st pillar
- Fully Funded 2nd pillar
- Third voluntary pillar

# Polish pension reform

Chart 11  
A three-pillar pension system



Source: Góra and Rutkowski (1998)

# Poland 1st pillar

- All the insured below 50 covered by the new NDC
- New pension based on contribution paid, accrual rate of return and life expectancy at the age of retirement
- Those above 50 stayed in the old PAYG scheme
- No early retirement provisions, statutory retirement age (60 W, 65 M)
- Price indexation of pension (since 2004)

# Poland 2nd pillar

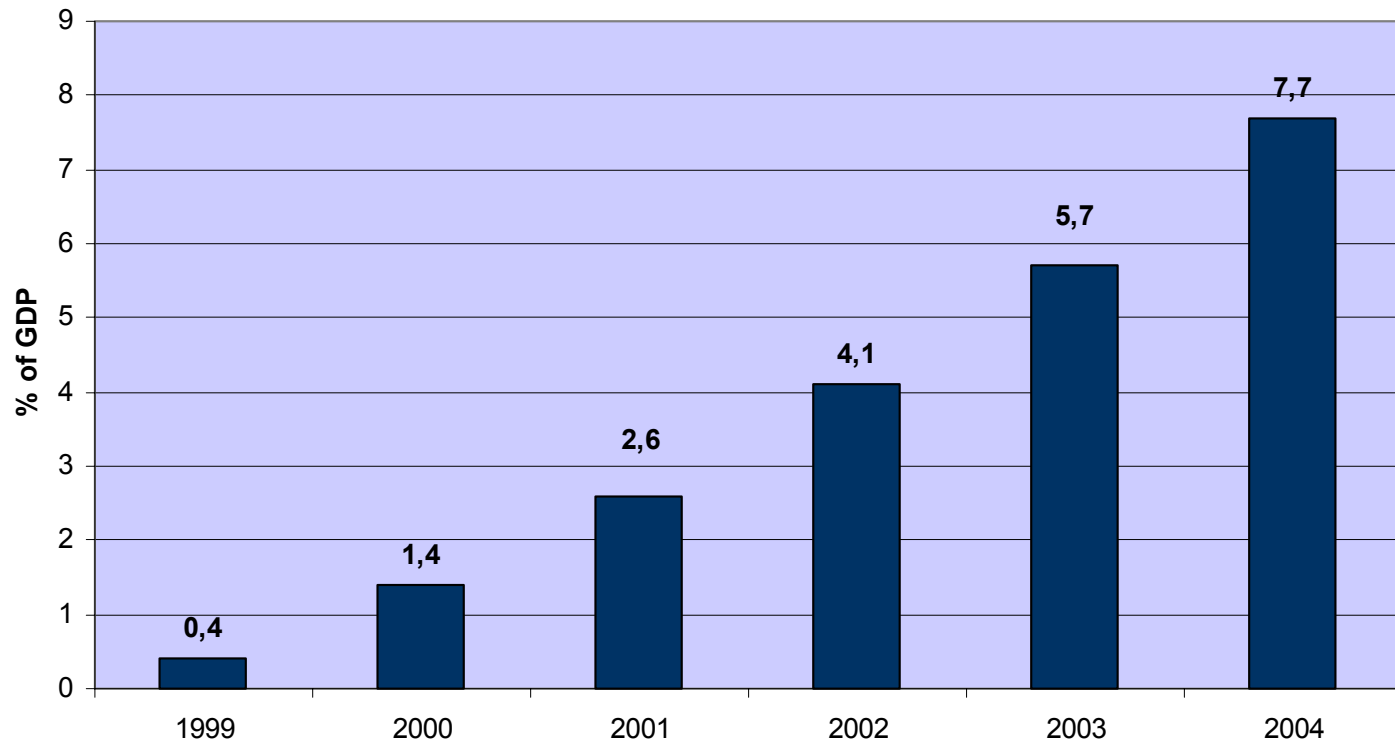
- Open pension funds
- 7.3% contribution out of 19.52% to pension funds
- All the insured below 30 were obligatory covered by the new system
- Those between 30-50 could chose till the end of 1999 whether to pay part of their contribution into II pillar or the whole to the 1st one
- About 8 milion participants
- 1.5% of GDP annual cost of the reform

# Poland 2nd pillar

- Investment limits (up to 40 percent in equities, maximum 5 percent abroad)
- Minimum rate of return (relative)
- Fee on assests and contribution (initially no restriction on contribution)

# Pension fund assets in Poland

Chart 12  
OPF assets in % of GDP



Source: Ministry of Finance

# Poland – unfinished agenda

- Sector privileges, phased out but still not fully solved
- Lack of pension payout legislation
- Lack of farmer's pensions reform

# Czech Republic –three stages

- 1990-1992 – removing of sector privileges and self –employed discrimination
- 1995 – gradual increase of reirement age (target 63 for men and 60-63 for women will be reached in 2013)
- 1997 – tightening indexation criteria (penalizing early retirement)

# Czech Republic – 1st pillar

Public pension consists of two tiers:

- Flat rate basic pension (18 percent of average old age pension)
- Income related part
- Current contribution rate 26 percent

# Czech Republic – voluntary scheme 1994

## Government incentives:

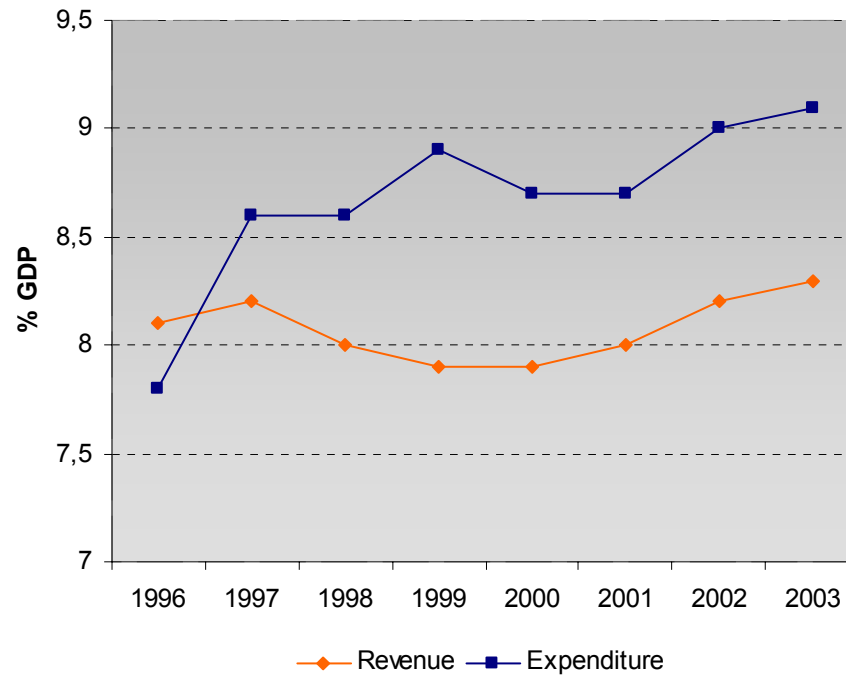
- State contribution to employee voluntary contribution (sort of subsidy)
- Tax allowances (since 2000)
- 40 percent participation

# Czech Republic – unfinished agenda

- Aging population and growing cost of the system
- Need to reform further current PAYG (from defined benefit to defined contribution)

# Czech Republic, ongoing deficit

**Chart 6**  
**Revenues, expenditure and balance of the public pension scheme, 1996-2003 (as % of GDP)**

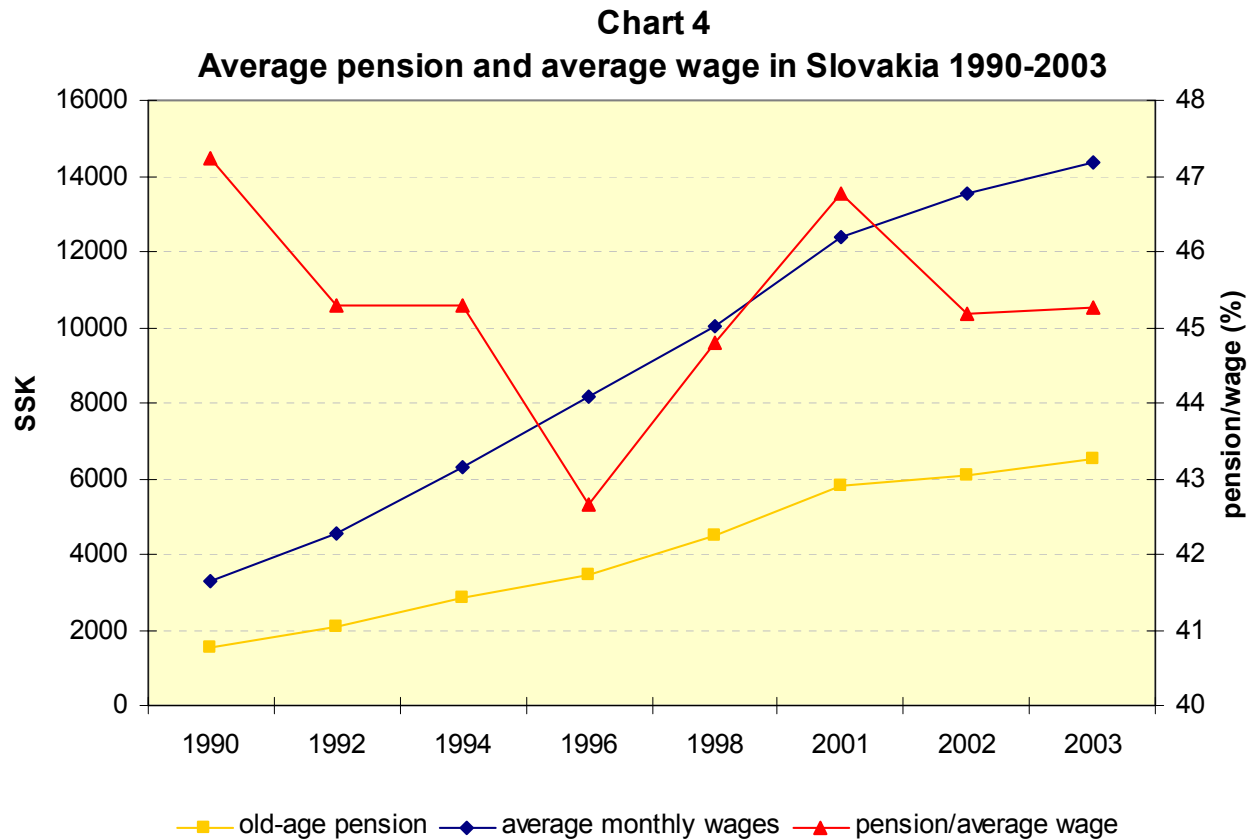


Source: Bezdek (2005), The public pension system in the Czech Republic from the point of view of Public Finance, Institute of Economic Research, Hitotubashi University.

# Slovakia - 2005

- Followed Polish model
- Three pillar system
- PAYG
- II pillar

# Slovakia, replacement rates



Source: INEKO

# Slovakia 1st pillar - 2004

- Rising retirement age (from 55 W and 60 M to 62 for both sexes)
- Change of the pension formula:

$$P = \text{POMB} * S * \text{ADH}$$

where, S- number of contributory years

POMB – ratio of individual gross wage to the average gross wage in the country

ADH – coefficient set by the law to ensure 50 percent replacement rate

# Slovakia, 2nd pillar: 2005

- private pension funds
- managing three funds (growth, balanced and conservative fund) to diversify portfolio
- 9 percent contribution
- Investments restrictions: 50 percent of assets to be invested in Slovakian securities
- Cost of reform - about 1% of GDP

# Conclusions

- Pension reform still on the agenda
- Population aging will force countries to move further with their reforms (Hungary and Czech Republic)
- But even reformed systems require some more actions to be taken (case of Polish farmers)