Pension reforms in Central and Eastern Europe (CEE): The case of Poland

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Outline of the presentation

- Why do CEE pension systems need reforms?
- Pre-reform pension developments in Poland
- The Polish pension system after reform
- Private pension funds in Poland
- Unfinished agenda and future challenges
Part I:

- Why do CEE pension systems need reforms?
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While the demographic situation in CEE is favorable compared to EU12…

Source: Eurostat.
...social spending is relatively high

Social benefits 2005 (percent of GDP) and GDP PPS

Source: Eurostat.
Long-term projections point to unfavorable demographic trends

Dependency ratio (60+/18-59), 2000-50

Source: Eurostat.
Fiscal positions provide little cushion against population ageing

Source: Eurostat.

Fiscal balance

Source: Eurostat.
Most CEEs implemented changes in their pension schemes:

- Numerous parametric changes to put PAYG schemes on a stronger footing, for example:
  - reducing early retirement provisions
  - changes in benefit calculation formulas
  - limiting occupational privileges
  - changes in the indexation of benefits
  - increase in the retirement age

- Some CEE countries diverted part of social security contributions to mandatory private pension funds: Hungary, Slovakia, and *Poland*
Part II:

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The Polish pension system acted as a ‘transformation buffer’ in the 90s

Annual change in number of pensioners (thousands of persons)

Source: GUS and ZUS
Consequently, the burden on working population has increased.

System dependency ratio: pensioners to contributors (in percent)

Source: GUS and ZUS
At the same time, replacement ratio has increased despite ad-hoc measures...

Replacement ratio: average old-age and disability pension to average wage (in percent)

Source: GUS
...and the social security fund was in large deficit

Social security fund (FUS): balance (before budget subsidy, percent of GDP)

Source: MoF and ZUS.
Part III:

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Basic features of the Polish pension reform in 1999

PAYG | FUNDED
---|---
DB | Old system
DC | 1\textsuperscript{st} pillar
New system
2\textsuperscript{nd} pillar
Expected impact of the reform

- In the *long-run*, the reform was expected to improve social security finances by:
  - lowering the replacement ratio for future pensioners
  - increasing effective retirement age—inter alia by eliminating expensive pockets of early retirement
  - shifting longevity and market risk to beneficiaries
- In the *short-run* the reform implied transition cost as part of the contribution was diverted to private funds
- On balance, the result was expected to be strongly positive
The reform was expected to stop deterioration in social security

Poland: The fiscal impact of the 1999 Pension Reform
(The balance of the state-managed part of the pension system relative to GDP)

Post-reform developments differed from assumptions

- Developments were less favorable, for example:
  - pensions increased faster than envisaged
  - the contractual employment declined
  - increasing self-employment weakened the contribution base
  - participation in the 2nd pillar was higher than expected

- As a result, the long-term turnaround in social security finances is not going to be as impressive as expected
Contractual employment has declined...

Contractual Employment (thousands of persons)


Source: GUS
...and pensions have been increasing faster than wages

Replacement rate (average pension to average wage, in percent)

Source: GUS and ZUS
Long-term improvement in social security looks less favorable

Balance of the state managed old-age pension fund 1999-2050 (percent of GDP)

Part IV:

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Open pension funds (OFE) at glance:

- **Membership**: mandatory for new entrants to labor market, voluntary for workers aged 30-50 at the time of reform, almost 10 million (80%) joined OFE (compared to 50% projected)
- **Contributions**: 7.3 percent of gross wage (12.2 percent for the state owned 1st pillar)
- **Fees**: on contributions (up to 7%) and on assets (up to 0.6%); some 1.6% of assets on average
- **Investment limits**: max. 5% foreign investments, max. 40% domestic equities, no limit on T-bonds
- **Minimum rate of return**: 50% (or 400 bps) below weighted average for all funds in last 3 years
- **Number of funds**: initially 21 OFEs, but declined to 15 after mergers; three largest funds account for 64% of assets
Assets of pension funds are growing rapidly

Assets of Open Pension Funds (percent of GDP)

Source: KNF, MoF
Asset structure remains stable

Structure of assets

Source: KNF,
Return on assets have been relatively high

OFE average nominal rate of return (in percent)

Source: KNF,
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Pending decisions and some future challenges

● Pending legal decisions:
  ● tightening early retirement regulations
  ● aligning the disability pension formula with DC scheme
  ● defining annuity rules

● Main future challenge is to avoid poverty traps and related fiscal pressure:
  ● increasing effective retirement age (mainly women)
  ● promoting voluntary pension savings
  ● broadening contribution base (self-employed)

● And…reforming the farmers’ pension system