WORLD BANK GROUP
Social Protection & Labor

Challenges of Pension Reform in Transition Countries: Europe and Central Asia

Anita M. Schwarz
Lead Economist
Social Protection and Labor Global Practice

Characteristics of Transition Countries

- Large percentage of elderly collecting benefits
  - All elderly worked for the formal sector and had complete work histories
- Relatively fewer workers contributing
  - High rates of unemployment as state-owned industries declined
  - Outdated skill sets of workers
  - Rise of informal labor markets
- High contribution rates
- Benefit levels – 2 groups of countries:
  - Relatively high benefit levels, particularly relative to country's average wage
  - Relatively flat benefits
    - Inflated away
    - Increases focused on lower earners

Additional Historical Characteristics of Transition Labor Markets

- Careers seen as single track
  - Ballerina should retire when no longer able to perform on stage
- Early pensions seen as substitute for workplace safety
  - Hazardous occupations given early retirement
- Pensions used to reward socially beneficial behavior
  - Women who bear more than 3 children
  - Women seen as working 2 jobs, one at home and one at work, given early retirement
- 30 years often seen as full career

Faced enormous financial problems in pension system

- Any system with lots of beneficiaries and few contributors will face financial pressures
- Political pressures against reforms
  - Large numbers of beneficiaries lobbying against reforms or at least for protecting benefits of current beneficiaries
- Financial pressures encouraged reforms
- Reforms took place in context of many other reforms
- Has been like a pendulum
  - Strong reforming governments followed by more populist governments
  - Particularly detrimental for pension policy because people are making contributions on the premise that they will receive benefits in 40-60 years

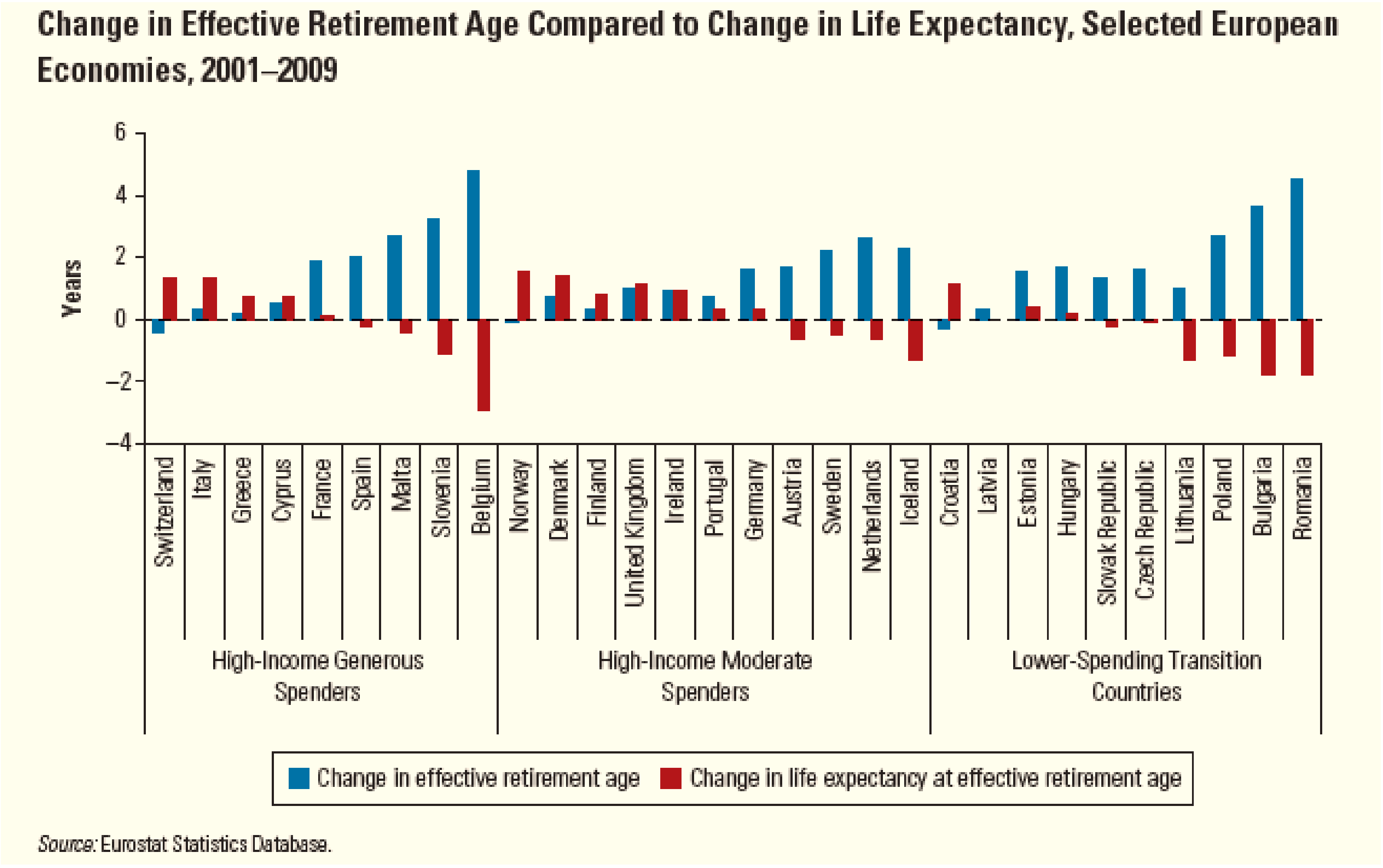
What Have Countries Done?

- Reforms focused partly on reducing spending
  - Restricted eligibility criteria
    - Raising retirement age
    - Tightening disability conditions
    - Raising years of service requirements
  - Reducing benefits in the long run
    - Basing benefits on full career salary
    - Indexing only to inflation
    - Lowering accrual rate
- Also focused on ensuring poverty prevention through generous indexation of minimum benefits
  - Some adopted by default or by choice for flat, universal benefits, sometimes complemented by savings pillar
- General emphasis on tightly linking contributions to benefits
  - Defined benefit systems based on average lifetime wages; point systems; notional accounts
  - Wanted pension differentiation to match newly differentiated wages
  - Wanted to use incentives to combat informality

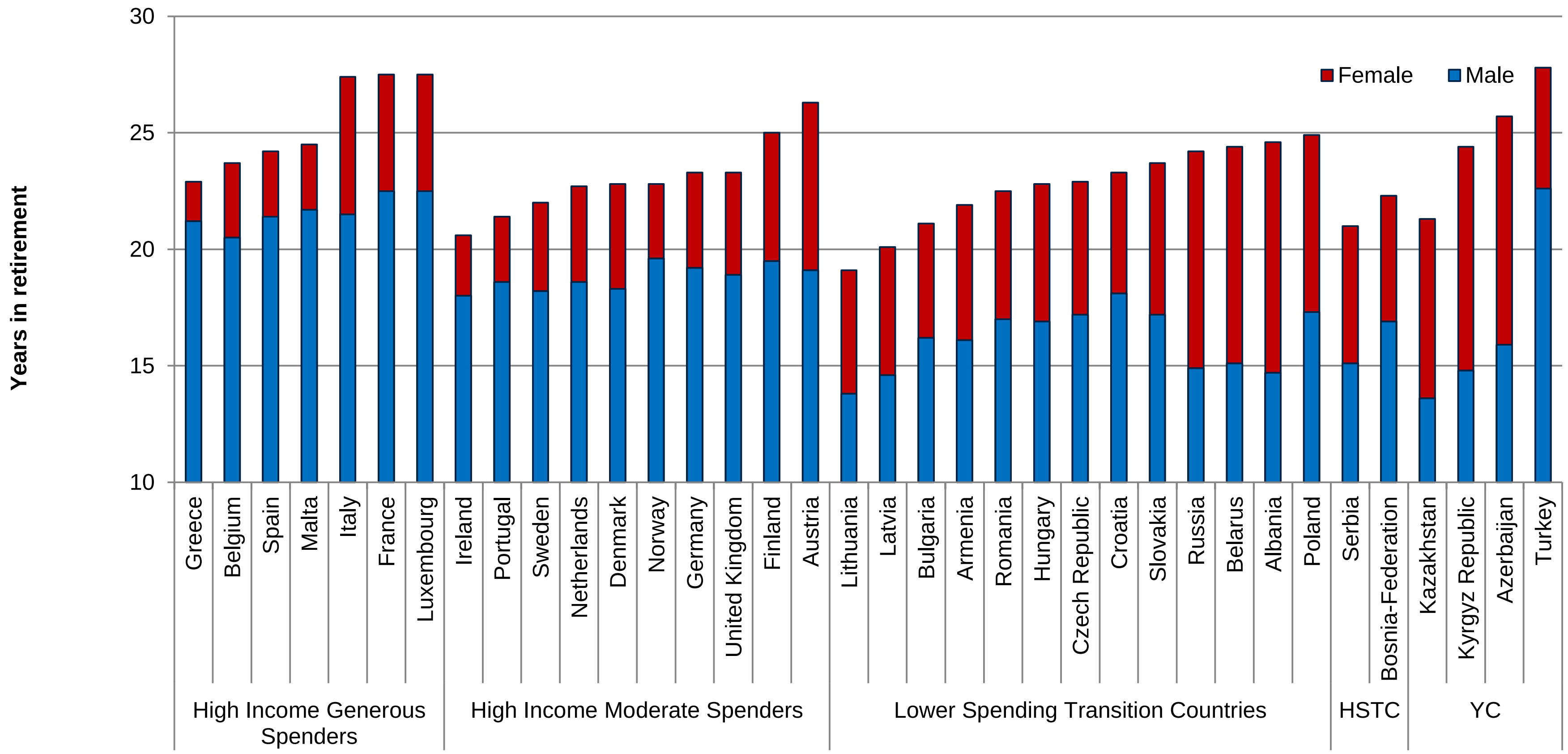
Almost half added savings pillars

- 15 out of 30 transition countries adopted second pillar (fully funded defined contribution)
  - Linked benefits to contributions and reduced public pension in long run
  - Mandatory contributions were divided so that one part when to public system and the other to private system
    - High initial contribution rates prevented countries from being able to add on additional contributions for savings
  - Led to even larger shortfalls in pension systems in the short and medium run

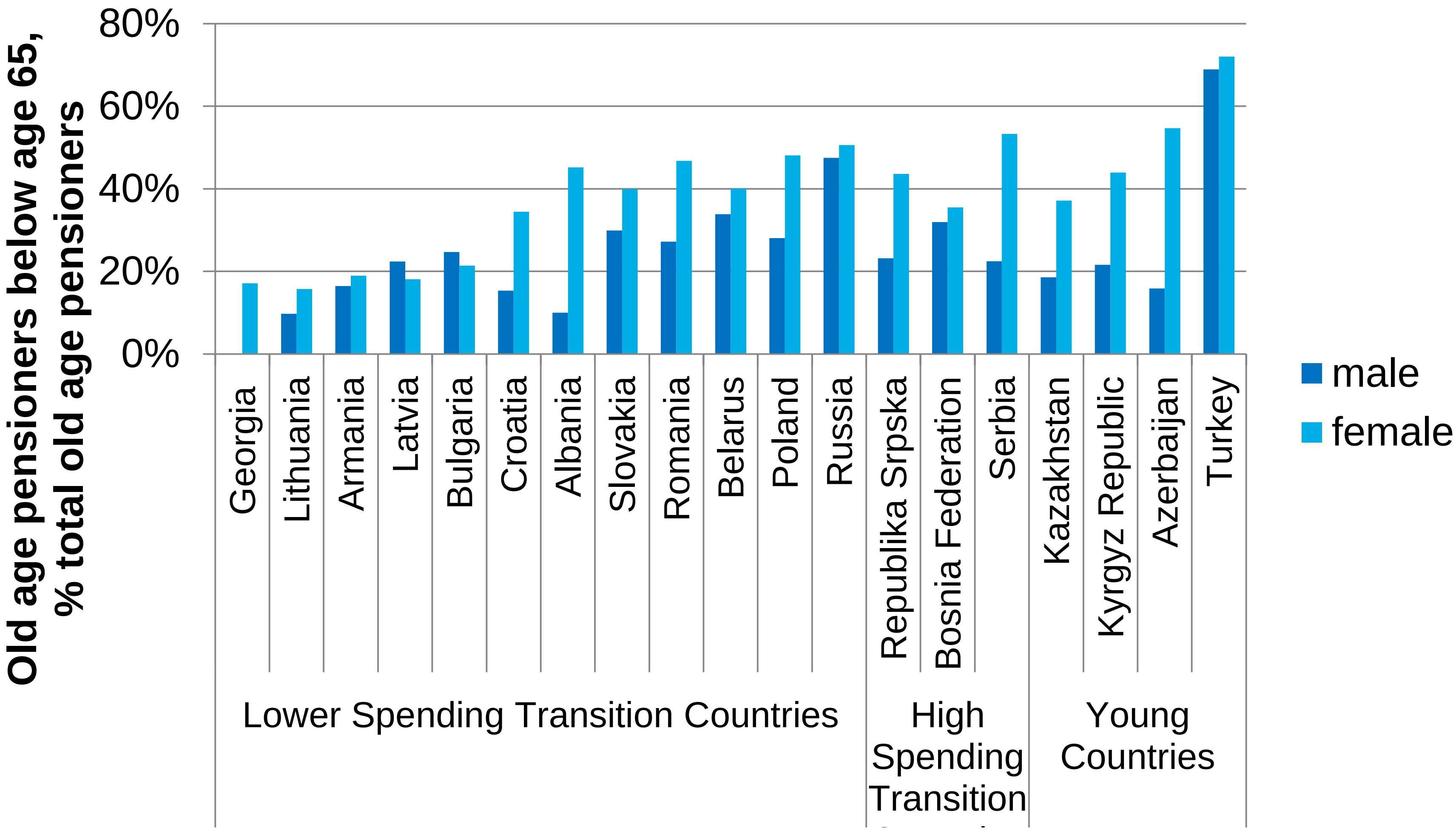
Retirement Ages Increased, but Duration of Retirement Did Not Fall Proportionately



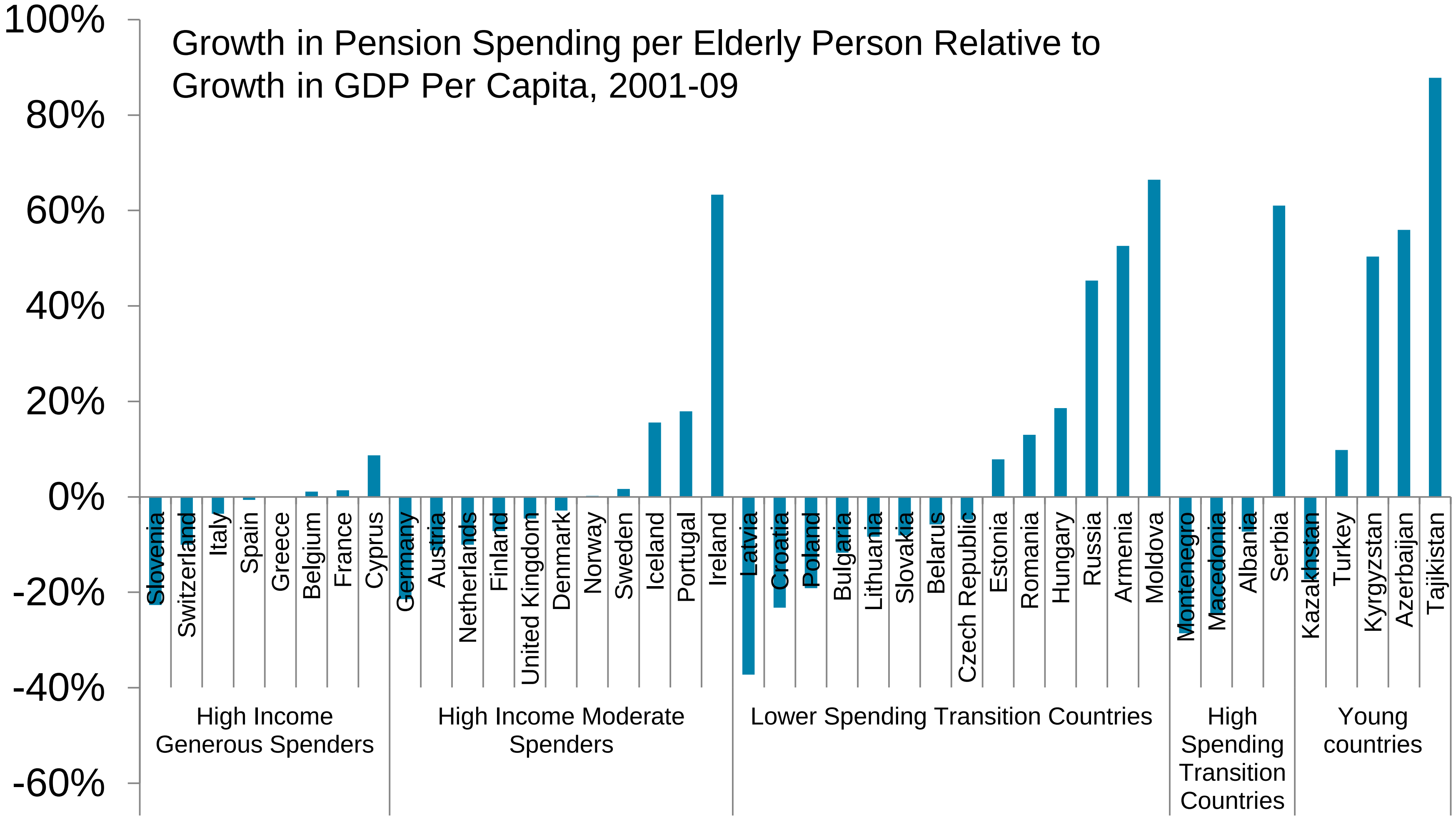
Duration of Retirement Still Remains Far Above 15 Years



Early Retirement is Still Prevalent



No Clear Trend-Line of Reduced Spending Per Pensioner



WORLD BANK GROUP
Social Protection & Labor

Savings Systems Not Entirely Performing as Expected

- Introduction of savings systems led to immediate deficits
  - Expected to be financed through:
    - Privatization revenues
    - Further reforms to public pension systems
    - Surpluses in general revenue
  - Actually financed through borrowing
- Investment returns were not as high as desired, and investments often in government bonds
  - Governments needed pension funds to finance fiscal deficits which ultimately crowded out potentially more lucrative private investments
- Fees in some cases were too high; in others too low

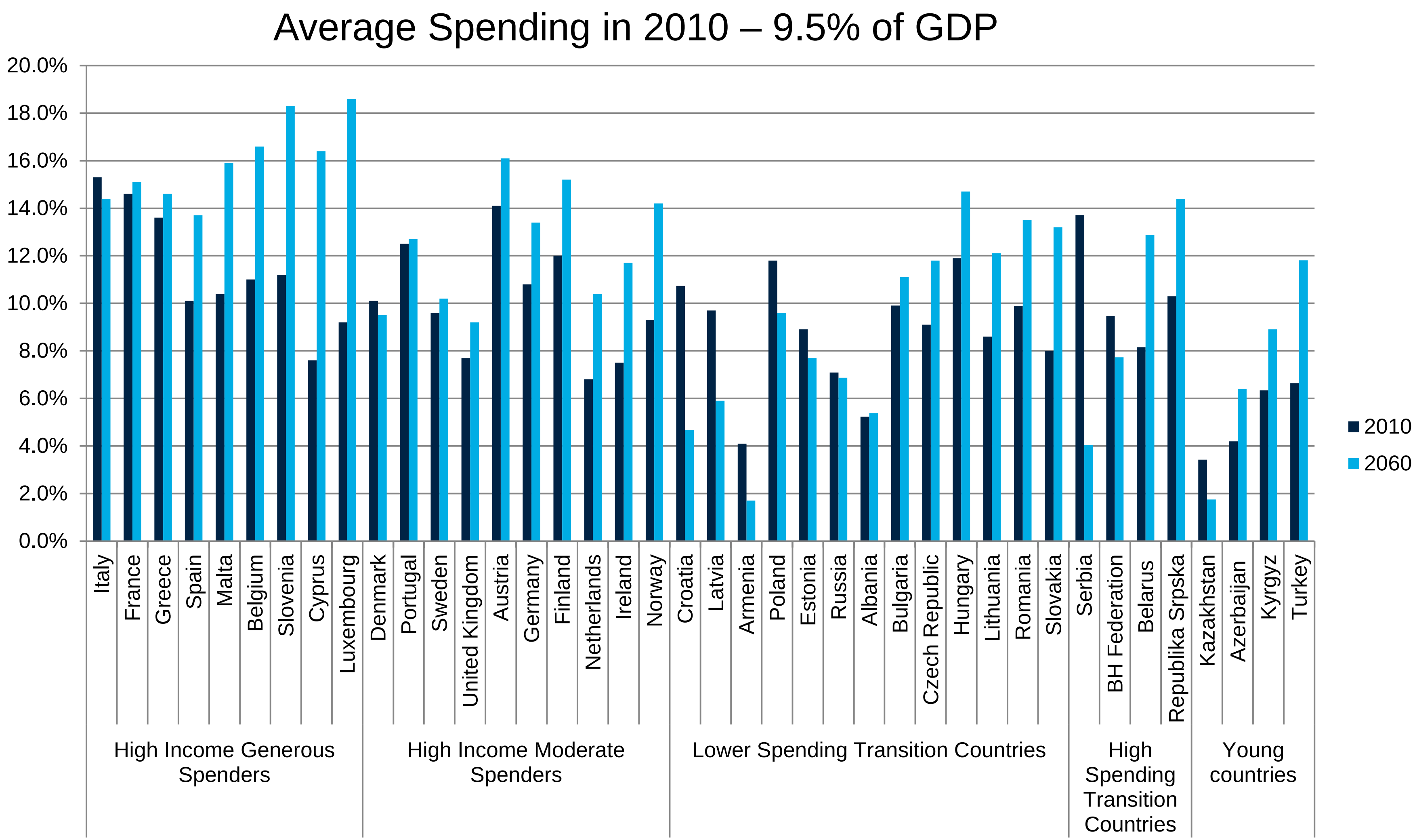
A Few Countries Scaled Back Savings Systems

- Hungary re-nationalized the pension system
- Poland, Slovak Republic, Latvia, and Russian Federation cut back on contributions to savings system

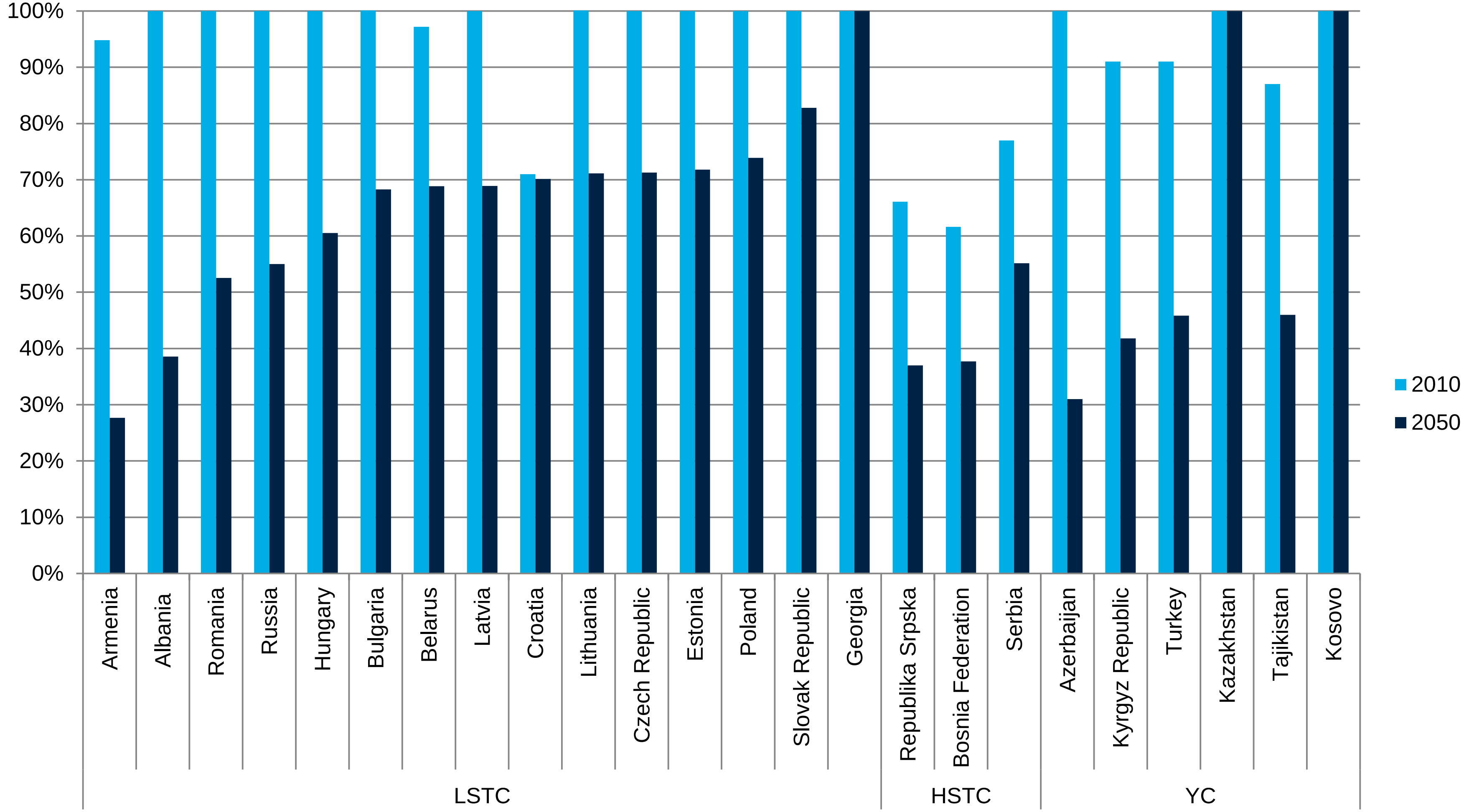
BUT

- This scaling back increases liabilities in the public system
- Or, may result in pensions which might be inadequate in the future

Projected spending in 2060 compared to spending as share of GDP in 2010



And this does not include all costs: The Number of Elderly Eligible for Pensions Are Expected to Fall Due to Informality Among Current Workers



Suggests That Additional Reforms May Be Necessary in the Future

- Countries will need some mechanism to provide at least minimal old age support for those who have not contributed much to the public pension system
- Countries will need to provide pensions at least able to provide poverty level benefits for those who have contributed
- By the time these two needs are met, there may not be many resources to provide pensions which prevent sharp drops in income as people transition from working age to retirement age
- May require mechanisms which will allow and encourage people to work longer
  - Flexible labor markets
  - Retraining opportunities
- Will need to encourage retirement savings