Pension Challenges and Pension Reforms for the countries of Eastern Europe, Caucasus and Central Asia

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Outline of the presentation

1. Current environment

2. Pensions: What, Why and How?

3. Pension Systems

4. Options for pension reforms

Current environment of ageing societies

1st factor: Increasing life expectancy

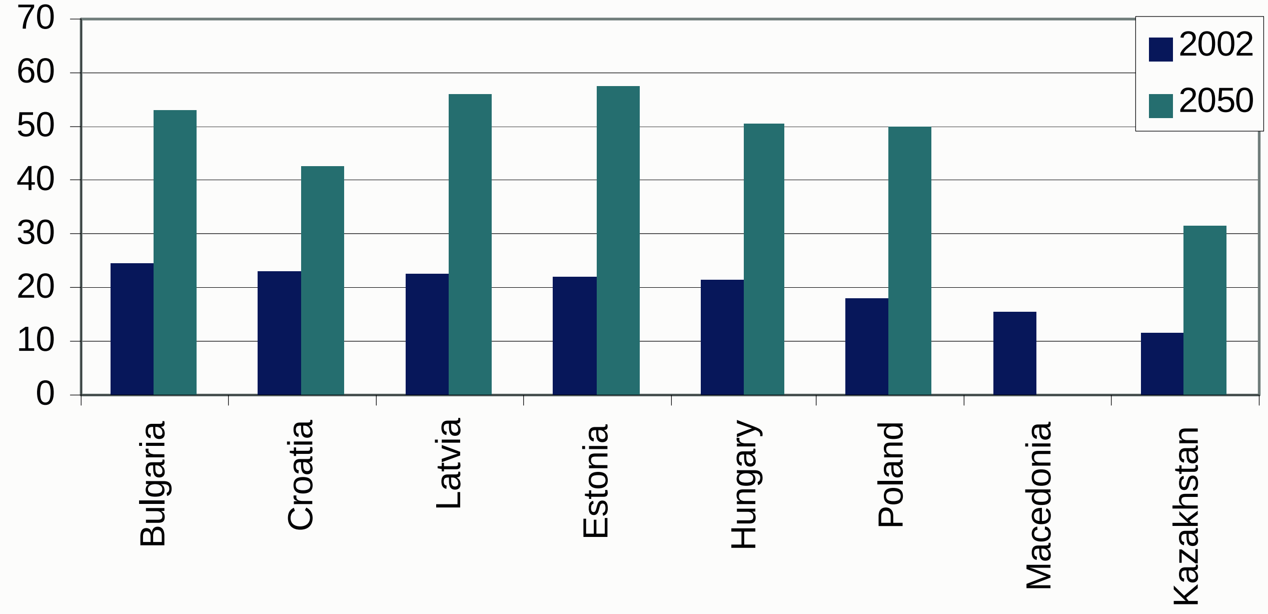
2nd factor: Declining fertility rates

Two factors together

- shifting the demographic structure so that a greater fraction of the population is formed by older population; countries going through this demographic changes are referred to as ageing societies.

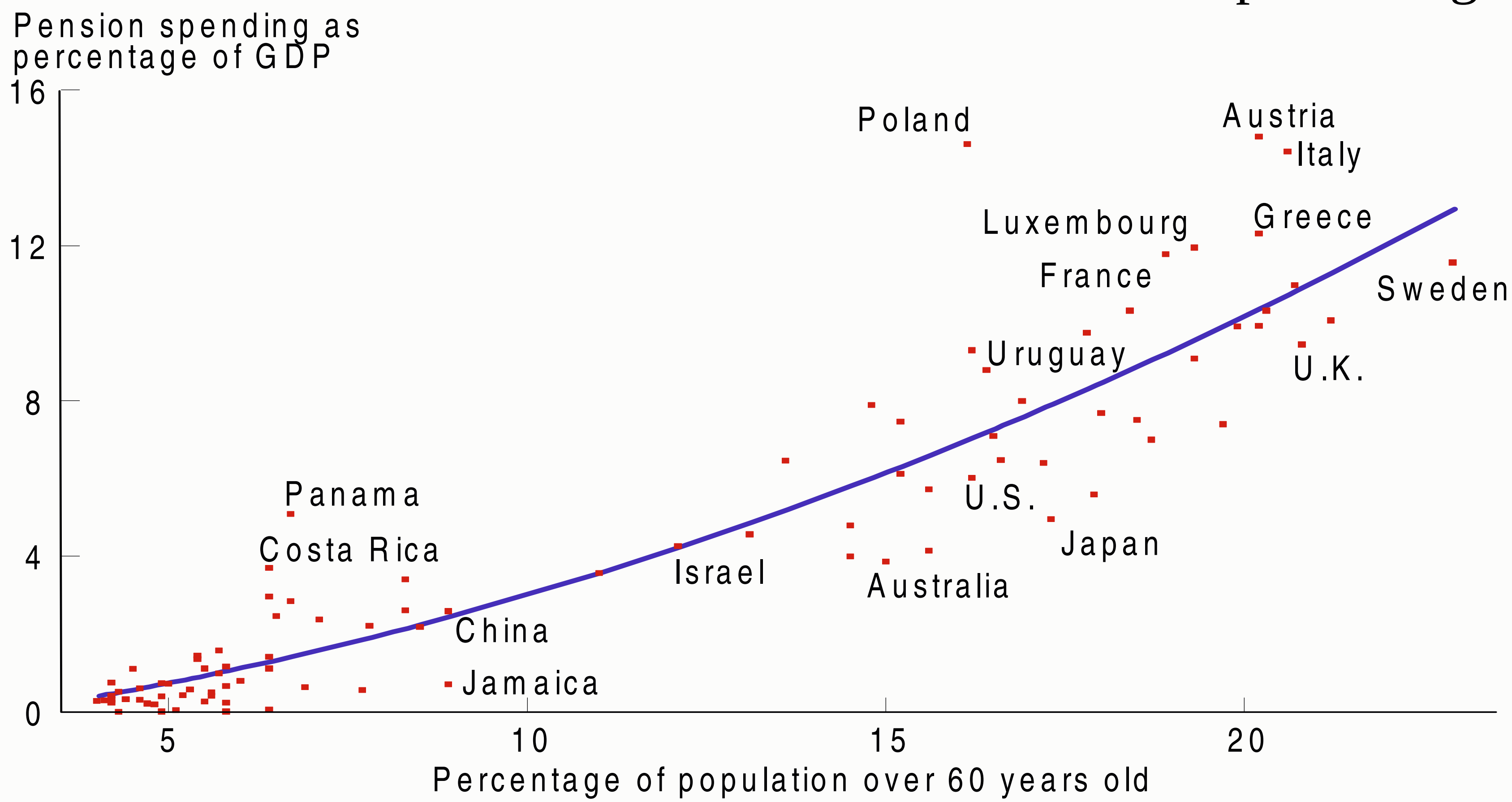
Population ageing

Demographic Dependency Rate (65+/15-64), per cent



And, an increased public pension spending

Relationship Between Percentage of the Population over 60 Years Old and Public Pension Spending



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2. **Pensions: What, Why and How?**
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What are pensions?

- **Typically an annuity,** which is a promise to pay a fixed amount of income over one's whole life post-retirement
- It could be a 'Level' annuity or an 'Indexed' annuity (with wage or price indexation?)
- It could be a 'Single' annuity or a 'Joint' life annuity with survivors benefits
- Pensions therefore serve as an income insurance against longevity; pension system serves as a vehicle to spread income from working life to retirement (and possibly some redistribution!)

Public Pensions, Why?

- ✓ **Myopia:** individuals acting like a grasshopper rather than an ant!
- ✓ **Vertical equity:** welfare state seeking access to adequate resources at all stages of life, thus redistribution over the lifecycle is sought
- ✓ **Horizontal equity:** differences between men and women, between whites and ethnic minorities be reduced for social justice reasons
- ✓ **Equity across generations:** future generations of elderly to enjoy at least as good a living standard as for the current generation; (what merits of funded and PAYG for this goal?)
- ✓ **Market failure:** Private insurance to provide low incomes to those with low death probabilities (e.g. women in comparison to men)

Public Pensions: how?

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✓ **Pure insurance:** dependent on contributions, and thus pension incomes will match the contributions (earnings related; consumption smoothing)

✓ **Pure redistribution:** non-contributory (e.g. citizen's pensions on the basis of residency status alone)

So, what are the implications for these differences?

And, is there an optimal mix?

No one size fits all!

And, what role for state in private pensions?

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- ✓ Increased incentives (through tax relief) towards higher private savings for pensions
- ✓ Information and education about technically complex financial instruments – generating trust and stability
- ✓ Incentives to employers to offer suitable pension schemes to all their employees
- ✓ Legislation to protect misselling of pension products
- ✓ Legislative funds to protect against the bust schemes
- ✓ Measures to reduce adverse redistribution

Thus, State should take responsibility towards providing an environment in which individuals have positive and consistent incentives to contribute for their own retirement.

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PENSION SYSTEMS

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The Multi Pillar Approach

PILLAR ONE	PILLAR TWO	PILLAR THREE
PUBLIC	PRIVATE	PRIVATE
MANDATORY	MANDATORY	VOLUNTARY
(DB schemes)	(Occ. pensions)	(Personal pensions)
TAX REVENUES/ CONTRIBUTIONS	FINANCIAL ASSETS/ CONTRIBUTIONS	FINANCIAL ASSETS

What are the crucial distinctions?

Organisation – public or private?

Participation – mandatory or voluntary?

Financing structure

– PAYG

- Fully funded

- Partially funded

Financing structure of first pillar

I. Pay-As-You-Go system

PAYG: incomes to current pensioners financed by contributions by current working age individuals; first tier financing

One crucial requirement in the PAYG scheme is:

$$t.w.L = p.\ D$$

or

$$t = p/w * D/L$$

where D/L = old age dependency ratio

and p/w is the relative generosity of benefits

PAYG: What are the reform options?

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$t = p/w * D/L$

✓ Increase L to offset increase in D
- discourage early retirement
- raise state pension age
- greater levels of female employment
- encouraging immigration/ reduce emigration

✓ Increase social contributions “t” (only a certain degree possible, otherwise they act as disincentives to work)

✓ Allow public pension benefits “p” to fall
- fall in public pensions (more poverty risks!)
- encourage persons to take out private pensions
- **means-tested minimum benefits as a social safety net**

Other financing structures

II. Fully funded system

- ✓ Shift towards individual accounts of pensions
- ✓ Costs of the transition from PAYG to funded system
- ✓ Longevity and investment risks transfered away from State towards individuals, but overall risks diversified
- ✓ Uncertainty of rate of returns!

III. Partially funded system

- ✓ Mix of PAYG and funded tiers (Poland and Hungary)
- ✓ Notional defined contribution system (Sweden)

Pension formula, how?

Defined Benefit (DB) schemes

- where the benefits are related to the member's earnings at retirement and length of service;
- typically each year of contribution earns you 1/50th of your final salary; used typically in PAYG type system

Defined Contribution (DC) schemes

- pension is income-linked to the fund value - this being dependent upon the contributions made into the fund, retirement age and investment returns; fully funded (not always!)

The DB-DC switch and its implications

- Risk transfers (but intergenerational fairness is better achieved)
- increasing complexity of decisions by individuals
- Hybrid DB-DC schemes (analogous to the multi-pillar system)

Influential models from CEECs

- **Poland** – 1st pillar: NDC (12.22% contribution rate); 2nd pillar: 7.3%; guaranteed minimum pensions from the first two pillars; and previous PAYG system to continue (similar in Latvia, Hungary somewhat different)
- **Kazakhstan** – fully funded system (Chilean style); social tax at 21%; previous PAYG system to continue paying disability, survivor and social pensions
- **Kosovo** – Three tier system: basic pension for all 65+ (non-contributory) **+** mandatory pension savings programme (DC, 5%+5%) **+** voluntary or employer provided schemes (with state regulations)

Influential models from other European countries

- **Netherlands** – Citizens' Pension is a model of simplicity and success!
- **Sweden** – The Notional Defined Contribution model adjusts automatically to provide the right incentives
- **Austria/ Germany** – strong contributory principles; now leading to hybrid schemes (DB schemes defined on the principles of DC)
- **UK** – Flat rate basic pensions; personal accounts (auto-enrolled, but not mandatory); company pensions with tax relief [highly complex]

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What reform options?

1) Rebalancing between pillars

- ✓ Shift focus away from public to private sector (thus, one pillar is divided into multipillars)

Introduce rules/mechanisms within the pillars

- ✓ PAYG rules adjusted, with defined contribution principle
- ✓ Tax incentives for private voluntary pensions
- ✓ Change/introduce variable retirement age
- ✓ Move to notional defined contribution system (1st pillar)

New pillars:

- ✓ basic guaranteed income (sometimes called zero pillar)
- ✓ non-income benefits (e.g. LT care; informal support)

Status of pension reforms: an example from European countries

Parametric Reforms

- ✓Attempt to rationalize pension system by seeking more revenues and reducing expenditures while expanding voluntary private pension provision.
- ✓Austria, Czech Republic, France, Germany, Greece, and Slovenia

Systemic Reforms

- ✓Fundamental change in pension provision: through introduction of mandatory funded pensions, with reforms of PAYG pillar and expanded voluntary retirement saving.
- ✓Bulgaria, Croatia, Hungary, Latvia, and Poland.

Reasons for Systemic Reforms

- ✓ Actuarial systems
- ✓ Improve fiscal sustainability
- ✓ Move towards the Defined Contribution principle
- ✓ Individual choice and responsibility to increase

Reasons for the multi-pillar reform

- ✓ to make the pension system sustainable in long run
  - ✓ to reduce implicit pension debt
  - ✓ to diversify risk
- ✓ to achieve better balance between collective and individual responsibility in the pension system
- ✓ to encourage additional savings
- ✓ to develop and strengthen financial markets

Reforms in CEECs

Reforms	*Country*
Going towards defined contribution	**Poland** **Latvia** **Croatia**
Reducing existing defined benefit	**Hungary** **Bulgaria** **Estonia** **Macedonia**
Flat rate minimum benefit	**Kazakhstan**

- ✓ to attain fiscal sustainability
- ✓ to find ways to meet the transition costs

Trends

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- ✓Trend towards multi-pillar schemes:
  - ✓Implemented in 8 countries
  - ✓Considered in Slovakia
- ✓Experiences up to now:
  - ✓high participation
  - ✓fast increase of pension savings
  - ✓concerns regarding transition financing

Lessons in move to 2nd pillar

Overswitching or underestimation?

- distrust to the public system
- belief in private savings?

Large concentration:

- biggest funds: bank or insurance backing
  - more efficient sales?
  - earlier presence on the market?

Little changes between funds

- design worked?
- outflow from public managers

A challenge for you!

What should your Government do?

✓**Nothing** – leave the present system alone? What will be the consequences?

✓**Minor reforms** – tidy up the public pension system and let the private sector respond?

✓**Root and branch reforms** – replace the contributory and means-tested systems (and move towards public DC system)?

✓**Look for a middle way** – addressing the weaknesses in the public and private systems?