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Session 3 : Social Security : Is It a Different Issue for Accession Countries ?

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Social Security Reform: Is It a Different Issue for Accession Countries?

A Note

by

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In this note, a question is asked whether social security system changes and challenges are different for accession countries than for those already belonging to the European Union (EU). In section 1, we look at the direction of reforms of the social security systems. Section 2 compares long term balances of PAYG systems. Section 3 looks at other factors that determine the direction of future changes. Section 4 lists key challenges and opportunities for accession countries in the social security area, and at accession costs. Particular attention is given to pension systems, as they constitute by far the largest element of social security. To capture relevant elements in parts of the note the EU group is broadened to incorporate other high income west European countries, such as Switzerland, and a term Western Europe (WE) is used. Correspondingly, the accession countries group² is broadened to cover other countries within the region which aim at joining the accession group soon, such as Croatia. The group together is called Central and Eastern Europe (CEE).

1. Direction of reforms

From an eye-bird's look at the reforms of the CEE social security systems it is clear that those countries tend to move to multipillar arrangements, where within the mandatory part of the system there are two pillars: a PAYG one, and a funded one, based on capitalized accounts (see Rutkowski 1998, and Lindeman, Rutkowski, and Sluchynskiy 2000). Those two pillars are complemented by a voluntary and supplementary third pillar. Four countries, Hungary, Poland, Latvia and Croatia, have already legislated multipillar systems. Six others, Estonia, Romania, Macedonia, Bulgaria, Lithuania and Slovak Republic are following with some that have already decided to do multipillar reforms (Estonia, Macedonia), some very close to that decision (Romania, Bulgaria), and some with early work-in-progress (Lithuania, Slovak Republic).

Table 1 below compares some of the key parameters of the reforms in four leading reforming countries that introduced or fully legislated the introduction of the multi-pillar system.

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² 10 accession countries are Estonia, Czech Republic, Hungary, Poland, and Slovenia (first group), and Bulgaria, Latvia, Lithuania, Romania and Slovak Republic (second group).

TABLE 1: FEATURES OF MULTI-PILLAR PROPOSALS IN SELECTED TRANSITION ECONOMIES

	Starting Date	First pillar	Projected pension fund assets in 2020 (% GDP)	Workforce in funded pillar (2000)	Switching Strategy
Hungary	January 1998	PAYG DB	31%	45%	Mandatory new entrants Voluntary others
Poland	January 1999	NDC	33%	70%	Mandatory < 30, Voluntary 30-50
Latvia	July 2001 (NDC January 1996)	NDC	20%	72%	Mandatory < 30, Voluntary 30-50
Croatia	January 2002	PAYG DB	25-30%	60-70%	Mandatory <40, Voluntary 40-50

Source: Lindeman, Rutkowski, and Sluchynskiy (2000). PAYG DB means pay-as-you-go defined benefit, switching strategy indicates ages for which a switch from a one-pillar to multipillar system is either mandatory, or voluntary or not available.

The above-described arrangements differ from what can be seen in Western Europe. Multipillar systems have existed in Switzerland, the Netherlands, the United Kingdom and Denmark for a long time, however, except for Switzerland, in a quasi-mandatory or voluntary form. The only new multipillar reform took place in Sweden where a small second mandatory pillar was recently introduced. Most of European Union countries neither have nor think of having a mandatory funded pillar, including the largest countries, such as France, Germany, and Spain.

2 PAYG challenges: the long-term balance of the pension systems and the role of labor market effects

Where is the difference coming from? Is it related to differences in conditions on the ground? To examine this a brief analysis of the situation of PAYG systems in CEE is done below, along with a look at other variables relevant for the choice of the direction of changes.

Pensions in the Central and Eastern Europe region average at least 8% of CEE GDP and are largely financed by taxes on labor income. Reasonable baseline projections envisage that the pension burden will grow well above 14% of GDP within a few decades, or even above 16% of GDP with expected fertility and mortality changes. Such growth is likely to generate social and political unrest, and unless managed successfully, could undermine growth in employment, which, as seen below, is critical to a balanced solution.

In addition, CEE countries finance their pension expenditures by social security contributions at very high rates ranging from 20 percent to almost 40 percent on a comparable basis. These rates are a reflection of high system dependency ratios (beneficiaries over effective contributors). The adverse effect of high contribution rates on the labor market, especially detrimental effects on labor demand in

the formal sector, should be a matter of serious concern of CEE policy makers. Accordingly, CEE countries face two simultaneous challenges for the sustainability of their pension systems: stabilization of pension expenditures *and* reduction in contribution rates.

To estimate the role of key factors that address these challenges, this section presents results of the analysis of a long-term balance of pension systems in a sample of 4 CEE countries.³ Though the analysis, most of which was originally published in Lindeman, Rutkowski and Sluchynskiy (2000), is rather standard, it takes on board more explicitly than usual the labor market factors that can have an important effect on both the contribution rates and the long term fiscal balance of pension systems. Key variables are the labor force participation rate, the employment rate, the size of the formal labor market, and the degree of labor hoarding. Improvement in those variables can partially offset the negative trend with respect to the sustainability of PAYG pensions and contribution rates.

The results are presented in Table 2. We first show what the current age profiles in the four countries will do to pension spending without any changes in policy and without any improvements in either longevity or fertility (2050 projected expenditures). This alone will cause expenditures to increase from an average of 9 percent of GDP in 1997/98 (line 1, last column) to 17 percent of GDP in 2050 (line 2, last column).

We then estimate the additional effects of probable changes in mortality and fertility to the baseline scenario (2050 expenditures with mortality and fertility improvements). Under this adjusted mortality/fertility scenario, expenditures would be approximately 14.5 percent higher (line 3), increasing average pension expenditures to 19.8 percent of GDP (line 6). Either spending would have to be reduced by 51 percent (line 7) of the 19.8 percent of GDP, or revenues increased by an equivalent amount, to compensate.

	Romania	Estonia	Lithuania	Poland	Average
1. 1997-98 expenditures (%GDP)	6.8	9.7	6.1	14.2	9.2
2. 2050 project expenditures (%GDP)	12.3	17.6	10.6	27.1	16.9
3. Combined demographic effects on 2050 expenditures, including:					
4. mortality	16%	11%	5%	26%	14.5%
5. fertility	27%	26%	17%	23%	23.3%
6. 2050 expenditures with demographic effects (%GDP)	-11%	-15%	-12%	3%	-8.8%
7. Required compensating effect to stay at 97-98 expenditure level	14.3	19.5	11.1	34.1	19.8
8. Combined labor market effects, including:					
9. LFP	-52%	-50%	-45%	-58%	-51%
10. Unemployment	-26%	-19%	-20%	-27%	-23%
11. FSP	-14%	-13%	-6%	-16%	-12%
12. Retirement age increases to 65/65	-4%	-5%	-5%	-4%	-4%
13. Real benefit relative to real wage growth	-12%	-3%	-11%	-11%	-9%
14. 50 percent	-30%	-30%	-33%	-15%	-27%
15. 0 percent	-24%	-24%	-27%	-27%	-25.5
	-41%	-42%	-47%	-47%	-44.3

³ Those four countries represent almost 70% of the population of the ten accession countries, and above 50% of GDP.

Table 2 then outlines the effects of the various factors relative to line 7, that is, expenditures in 2050 with mortality and fertility improvements. Noteworthy is that increased revenues from the combined labor market effects would go a long distance in filling the gap – about 60 percent of the average compensating gap. The least scope for optimism about potential contribution of improved labor markets is in the Baltic states of Lithuania and Estonia, where current LFP and/or FSP rates are relatively high at present.

Table 2 indicates that three main factors that can help in stabilizing pension expenditures by 2050 – labor market effects, retirement age increases, and pension indexing (proxied by real benefit growth relative to productivity) – have roughly similar impact. None of them alone can stabilize expenditures, however, *two of the three together can almost do this*.

Our analysis suggests two broad conclusions. The first is that microeconomic incentives encouraging labor market participation and employment will play an important role in re-balancing mandatory pension systems. The second is that in order to achieve both the stabilization of pension expenditures *and* the reduction in contribution rates, it is essential to focus on factors that improve the system dependency ratio, that is, retirement age increases, reduction in unemployment, improved labor forced participation, and reduction in the share of the informal economy that does not contribute to the pension system.

In terms of policy implications, our analysis emphasizes that although pension policy is but one tool in changing those labor market incentives, careful attention should be paid in pension redesigns to encouraging long term labor force participation with clear rewards at the margin for paying contributions, especially at older ages.

The results are very similar to the results obtained for a large sample of West European countries (see Boldrin, Dolado, Jimeno, and Peracchi 1999). *In both analyses labor market effects combined with indexation of pensions not above the half of the wage growth make it possible to maintain the pension fiscal burden at or below the current level for the next 45-50 years (see ibidem p. 304-305).*

Therefore, with respect to the pension burden of PAYG systems, WE and CEE countries are very much alike. Why then are multipillar systems more popular in CEE countries, even though their introduction increases, rather than decreases short-term fiscal costs?

3. Other factors determining the choice of reforms

The answer seems to lie in factors outside pre-reform pension systems. First and foremost, CEE countries have a high target GDP growth rate as they want to catch up with European Union countries at some point in the future. Therefore, the objectives of pension reforms incorporate having a growth-friendly pension system and this points them in the direction of a funded pillar as it is believed to be conducive to growth through a higher savings rate and a higher share of long-term savings in the total pool of savings. This also calls upon better microeconomic incentives and more transparency in the PAYG pillar, and explains the popularity of notional defined contributions (NDC) arrangements in the PAYG pillar⁴.

⁴ NDC PAYG pillar has been introduced in Latvia and Poland, while Sweden is the only West European country having one. The NDC system makes the pension dependent exclusively on the sum of contributions paid divided up by the average life expectancy at the age of retirement. It is similar to the French point system, except that there is no way to change the value of the point arbitrarily, as this value in the NDC system is exogenous. An NDC system is the closest approximation of a funded system within PAYG arrangements. Even where it is not used, the concept is a useful anchor in helping specify

Higher potential growth rate has a lot to do with the development of the financial market. Here, CEE countries are long behind WE. An upside of that is that an introduction of a mandatory funded pillar quickly changes the architecture of the financial market, with pension funds becoming major institutional investors, and the size of pension savings reaching a significant (up to 40%) share of GDP. A multipillar reform is very helpful as a means to accelerate financial market development. Correspondingly, the share of retirement income received from private sources is significantly higher in WE than in CEE.

Finally, CEE countries are in slightly more advantageous position vis a vis WE countries, as far as transition costs of the reform are concerned. Their gross pension implicit debt⁵ is on average around 300% of GDP, while in the WE it exceeds 350%.

Table 3: Gross Implicit Pension Debt (% of GDP)

CEE		WE	
Croatia	274	Finland	384
Estonia	268	France	318
Lithuania	221	Germany	348
Poland	362	Italy	401
Romania	386	Sweden	370
Average	302		364

Source: R. Palacios and M. Pallares-Miralles (2000. p.32) and data provided by M. Pallares-Miralles.

4. EU accession challenges and opportunities

On their way toward European Union accession countries face formidable challenges. From the point of view of their social security system, coping with those challenges will be judged as success if those countries end up with solid, portable systems that (i) are conducive to growth, (ii) support the EU common labor market objectives, (iii) provide solid minimum social security package, and (iv) take advantage of the Union with respect to rate of return to pension contributions.

Key challenges in front of accession countries are the following:

(i) Dealing with implicit debt in the situation when its conversion into an explicit debt (an important ingredient of reforms) is constrained by a ceiling on budget deficit and debt, as set in the Maastricht Treaty

(ii) Adjusting systems to comply with *acquis communautaire*, which essentially means that social protection legislation should be consistent with free movement of people and ability to work in any EU country; those adjustments create costs related to summing up the social insurance period,

parametric changes in more conventional DB formulas (e.g., for setting the value of credit for delayed retirement or the decrement for early retirement). It is also important for coverage of pension systems. Making formal retirement system portable, transparent and flexible is an important condition for maintaining or achieving high coverage. See Holzmann, Packard and Cuesta (2000).

⁵ This is gross pension debt that includes present value of future pensions due to both past and future contributions of current workers. See Holzmann, Palacios, and Zviniene (2000) for definitions.

administrative costs of servicing the insured, as well as costs healthcare for CEE nationals working in the EU.

(iii) Acting upon Brussels Social Charter of 1992, para 51 in terms of ensuring rights of the population to social protection, that is, social insurance, health care, unemployment assistance, family benefits, and social assistance.

(iv) Adjusting privately managed savings to EU rules. The key problem here is that at the moment *different tax rules apply across the EU*. As private pensions become more important, these cross-border issues will increasingly inhibit mobility of labor and may even become as important a barrier to movement as language or housing. Even though some cross-border difficulties could be resolved on a bilateral basis in tax treaties, many of them will not. It would be helpful to have a unified EU approach to them, or at least an agreement that tax relief is always given for pension contributions, but pensions are taxed when they are paid.

From among those four challenges, challenge (ii) and (iii) are likely to be coped with successfully without much assistance from EU countries. However, help is needed with respect to challenges (i) and (iv). With respect to challenge (i) it would be appropriate to rethink the treatment of explicit debt if its increase comes as a result of a decrease in an implicit pension debt. Well-informed investors, understanding that there is a structural reform underneath would not see the increase in explicit debt and a loosening of economic policy. With respect to challenge (iv) significant changes within EU countries are needed, not only with respect to tax codes, but also, or even first and foremost, with respect to removing huge distortions within national pension systems of many EU countries, including the largest ones.

A prize down the line is high for accession countries, but the way is long. Already now, more reformist accession countries benefit from good EU directives governing annuity providers and allowing the best life insurance companies to come to CEE markets. They will hopefully benefit soon from gender equality practices forcing badly needed equalization of retirement ages, and from the rules prohibiting restrictions on investing within EU. There is much more to come, conditioned upon mutual understanding between accession countries reformers and EU governments.

5. Conclusion

Social security reform *is* a different issue in accession countries. Potential benefits from reforms are higher, while costs are lower. Not surprisingly accession countries embraced multipillar reforms, as well as more radical approaches within PAYG pillars, more readily than EU members. Accession countries should be assisted in this endeavor by quicker reforms within EU with respect to transparency and portability of pension plans, more consistent taxation systems, and recognition that pension reforms may legitimately cause transition costs appearing as higher budget deficits and higher explicit debts.

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