Averting the funding-gap crisis: East European pension reforms after 2008

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Abstract

This paper analyses pension reforms in Central and East European Countries in the aftermath of the 2008 financial crisis. The crisis revealed unresolved problems in the implementation of previous reforms, namely, the financing of the transition costs. In their attempts to solve the funding-gap issue, the reforms needed to address legacies of past choices as well as the exceptional circumstances of the crisis. The interaction of fiscal constraints and political conditions shaped the variety of these reform outcomes.

Introduction

The 2008 crisis marked a turning point in the evolution of pension systems in Eastern Europe.[1] Before 2008, a majority of countries in the region had reformed their pension systems along the model laid out by the World Bank (WB) in its influential 1994 report, *Averting the Old-Age Crisis*. In contrast, pension reforms following the financial crisis were far more diverse. Some countries de facto nationalized their private pension funds, while others temporarily diverted contributions from private accounts into the public pillar and/or downsized the second pillar.

This paper analyses pension reforms in Central and Eastern European Countries (CEECs).[2] It assesses the impact of the financial crisis on the political economy of pension reform and the changing political economy of pension privatization. In particular, it focuses on a key aspect of post-2008 reform: the solutions to financing the transformation costs of pension privatization.

Two claims are made on politics and political economy of the reforms. First, pension privatization is still on the agenda in Eastern Europe, but the politics of reforms changed. One of the countries that had not privatized before 2008 implemented pension privatization according to the standard WB model. There were also attempts at further liberalizing of privatized pension and moving closer towards the old WB model. However, as the WB and other international actors had stopped promoting pension privatization, it became an issue of domestic politics and an agenda of liberal right-wing parties. Second, the political economy of reforms also changed after 2008. The funding gap in covering the transition costs became the key issue. The unresolved problem in the implementation of earlier reforms became apparent and had to be addressed. The reforms were therefore both reaction to the legacies of past choices and to the exceptional fiscal circumstances that came with the crisis.

The outcome of pension reform policies in CEECs is discussed in the next section; this is followed by an analysis of the different solutions to the funding-gap problem, showing that financing through debt was a key implicit option. The remainder of the article focuses on the politics of pension reforms after 2008. The diversity of reform outcomes in CEECs is explained by the combination of economic constraints and political factors. The need to pursue fiscal stabilization set the parameters for manoeuvre. However, the reaction was also conditioned by ruling party ideology and cabinet composition.

Reform Outcomes

In the first-wave of reforms in the late 1990s and mid-2000s, the majority of CEECs pursued pension privatization by implementing a three-pillar pension system (Table 1 provides an overview of pension-reform trajectories in all East European new EU member states). These pillars comprised: a publicly financed pillar – based on the pay-as-you-go (PAYG) principle; a compulsory fully-funded second pillar; and a voluntary fully-funded third pillar.[3] The

Czech Republic and Slovenia were the only countries that did not implement this WB-style pension reform. They pursued only parametric reforms in their state-run PAYG schemes.[4]

The second wave of reforms after 2008 saw a wide range of outcomes. Slovakia retained its second pillar and further attempted to decrease the redistributive nature of its pension system as well as the involvement of the state. The 2010-2012 right-wing coalition proposed an overhaul of the pension system that allowed for automatic and continuous adjustments of pensions awarded to new retirees. However, this reform was not implemented following a no-confidence vote on the government in October 2011. Poland also remained committed to the three-pillar system, but it substantially reduced the size of the program. The reform in Poland was implemented by a government led by the liberal right-wing party, Citizen's Platform (PO) – historically a champion of pension privatization. The Czech Republic eventually implemented pension privatization as well, albeit at a more modest level than was common in the first wave of reforms among the CEECs. The reform breakthrough came after right-wing parties gained a strong majority in 2010. However, the second pillar (which is to be created in 2013) remains voluntary, with the requirement that those that opt for membership in the plan contribute an additional 2 per cent of gross salary. Of the group, only Slovenia remains a non-reformer. In 2010, the social-democratic-led government attempted to stabilize the pension system by gradually increasing retirement age, however the initiative failed due to a union-initiated referendum against the measure. Hungary *de facto* nationalized its second pillar following an election of the right-wing Fidesz in 2010. The savings accumulated in the private funds were automatically transferred to the state by June 2011. While savers had the option to stay in the private system, the conditions set by the new law were so unfavorable that only 3 per cent chose to remain (Simonovits, 2011: 93). As of January 2012, all pension contributions, including those paid by savers that remained in the second pillar, flow into the public PAYG system.

These second wave pension reforms – despite their diversity – have one thing in common: they all reacted to the problem of financing the transition costs of pension privatization. As discussed in the following section, this problem remained unresolved in the first wave of reforms.

The Funding Gap

Pension privatizations in CEECs were legislated in states that already had mature PAYG systems. Active-age population and present pensioners had already accumulated pension rights, representing future liabilities on state budgets. PAYG systems cover pensions from present revenues. Pension privatization simply diverted part of these contributions to fund the second pillar. However, the subsequent funding gap in the first pillar was a result of the loss of resources previously designated to finance the pensions of those with accumulated pension rights. Diverting contributions also leads to a reduction in contributor's pension rights (i.e. claims on the budget after they retire). The funding gap that resulted from the first-wave reforms thus represents the transition costs of pension privatization.

As described, the transition costs are the result of pension contributions lost from the PAYG system due to the introduction of the second pillar and the subsequent claims on the PAYG system that the state avoided through the same mechanism. A stylized depiction of the development of this funding gap can be seen in Figure 1. After introducing the second pillar, the number of people in the non-contributing workforce increases, while those who could in theory reduce the burden on the state – by receiving part of their pension from the second pillar – will in fact end up retiring decades after the reform has been introduced.[5] For instance, the transition costs of the Slovak pension reform adopted in 2005 were expected to peak around 2030, when costs would have reached approximately 2.9 per cent of the country's GDP. After this point, the number of retired workers who rely on the second pillar would have started to grow, thus reducing the annual transition costs. Contributions lost and benefits spared due to the introduction of the second pillar would have evened out around 2052 (Ódor and Novysedlák, 2005).

Some proponents of pension privatization question the relevance of transition costs, claiming they merely amount to the implicit debt of the PAYG system being transformed into explicit debt.[6] While the latter statement is factually correct, it indicates a misunderstanding of the difference between implicit and explicit (real) debt. On the one hand, there is a conflation of implicit debt and real deficits that can be generated by the PAYG system; on the other hand however, the misunderstanding can lead to the perception that the funding gap and the transition costs would be faced by governments in the future anyway in the form of a PAYG deficit. As this is incorrect, a short clarification is warranted.

Implicit debt is a theoretical construct that refers to expected liabilities in the form of payments to pensioners due in the future (see Cheikh and Palacios, 1996; Holzmann, Palacios, and Zviniene, 2004). In a PAYG system, these liabilities are financed by current revenues. The expected revenue streams could thus be understood as implicit financing. Real deficits can occur if current revenues do not match current liabilities. Over the long term, a PAYG system can therefore generate real deficits, or surpluses, if implicit debt and financing do not balance.

It is important to note that both implicit debt and implicit financing are mere theoretical concepts based on predictions about an uncertain future. Both of them depend to a large extent on pension legislation, which provides the necessary tools for balancing state-run PAYG schemes. Furthermore, future legislation-based liabilities of the state towards its citizens are of a very different nature than current accumulated debt, which is often held by non-residents (foreign investors). Implicit debt is a future liability that is theoretical and partly dependent on the creditor's own legislation. By contrast, transition costs constitute a current and real liability that is often accumulated against foreign entities.

Finally, transition costs should not be understood as the funding of potential future deficits resulting from demographic aging in a PAYG system. The introduction of a fully funded second pillar was seen as a solution to this problem during the first-wave of reforms. However, from a macroeconomic perspective, a shift to funding is at best secondary since the only real measure to effectively counter demographic aging is the retention of output levels (Barr & Diamond, 2008, p.94-104).

In addition to the costs of demographic aging, the funding gap created by pension privatization therefore represented a real liability that states needed to face in addition to the costs of demographic aging (see Table 2 for data on reformers in CEECs). Transition costs could have potentially been covered through several means: increasing taxes; cutting spending in the general budget and/or the PAYG scheme; or by using the exceptional revenues from privatization. In addition, it was argued during the first wave of reforms that pension privatization could be (partly) self-funding and even generate additional revenues by increasing output and formal employment. Private pillars were therefore expected to motivate workers in the shadow economy to formalize their status since contributions paid would not be redistributed, but rather paid into workers' private account. Privatization was also expected to increase output by channelling savings into more productive segments of the economy. However, such an effect is far from automatic as it requires a number of demanding assumptions to be met.[7]

In Slovenia, the funding-gap problem was a major reason why the country did not pursue three-pillar type reform.[8] Among the reforming countries, recognition of the funding-gap problem increased only gradually as reflected in the financing plans. In Hungary, little attention was given to the funding-gap problem at the time of reform. Polish reforms did include plans to mitigate the problem, although they have gone largely unfulfilled. A late reformer, Slovakia allocated actual privatization receipts and created additional revenue streams to fund the transition costs. However, none of the funding plans proved sufficient to meet actual needs.

In Hungary, the funding-gap problem did not seem to have entered public discussion in the reform of the mid-1990s. Given the understanding of the advantages of the fully-funded systems in the debate at the time, the social democratic government assumed that the introduction of the three-pillar system would result in increased employment and economic growth that would enable future governments to fill in the gap created in the first pillar. There was no intention to cut first pillar contributions to fund the transition costs nor was there any real political will to balance the first pillar until 2010. To function properly, the state-run PAYG pension scheme required a subsidy of 2.34 per cent and 2.0 per cent of GDP in 2009 and 2010, respectively.

In Poland, the pension reform funding gap was to be financed by rationalizing the first pillar with new price-based indexation and by withdrawing early retirement options after 2006. Revenue from privatization was expected to cover initial costs before the rationalization of the first pillar became effective in financial terms. The reformers therefore expected the annual deficit of the PAYG system caused by the diversion of funds to the second pillar to be less than 1 per cent of the GDP initially (Epstein and Velculescu, 2011) and to generate a surplus after 2012.[9]

However, reality showed the transition to a three-pillar system to be more difficult than initially thought. In 2000, the increase in the annual deficit of the PAYG system due to the second pillar was approaching 1.5 per cent of Polish GDP, and was constantly growing (see Table 2). The number of people joining the new system at this time was also considerably higher than expected: 10.5 million enrolled in the second pillar in 1999 as opposed to the expected 6-7 million (Hausner, 2002). Compounding the problem, privatization of state companies moved too slow to cover the costs (Golinowska and Zukowski, 2011) and, most importantly, savings in the first pillar proved to be politically unfeasible due to electoral constraints. Pension indexation did not survive the debate in parliament on the original reform package and the ratio of the average pension to the average wage increased from 2000 to 2004. Although price indexation was introduced in 2005 by a centre-left government, pensions returned to the mixed price-wage principle introduced by the pre-2007 conservative-right government. Moreover, the initial plan was not followed in cases of early retirement nor was the retirement age for men and women equalized. Finally, a number of preferential treatments were introduced: Judges, miners, and army and police officers were excluded from the general defined-contribution system in 2003 and 2005. The disability insurance contribution rate was cut in 2007 (Bielecki, 2011; Égert, 2012). As a result, the total level of annual pension expenditure in Poland increased annually by around 0.5 per cent of GDP between 1999 and 2009 (Chłoń-Domińczak and Stańko, 2011).

In Slovakia, the financing of transition costs was given more prominence than in Poland when implementing pension privatization. In the debate preceding the reforms a two-part solution was proposed: first, receipts from the privatization of the national gas company – 4.38 per cent of GDP (2005) – were put aside to finance the new system and cover the first five years of the program (2005-2010). Second, the government established a so-called 'Reserve Fund of Solidarity' in 2003 that currently collects contributions at a level of 4.75 per cent of the average salary. Although the fund was intended to cover deficits in social security in general rather than to finance pension privatization, at present its has only ever been used to cover the deficits in the PAYG system. Following a left-wing victory in 2006, no Slovak government seriously attempted to raise money through privatization; and so, the Social Insurance Agency still relies entirely on the state to cover its increasing deficits.

There were a number of reasons why the plans to finance the transition costs proved unrealistic among these first-wave reformers. Primarily, the reformers underestimated the numbers of individuals entering the second pillar, leading. This subsequently caused the funding gap to be similarly above estimates. In addition to this miscalculation, the expectations that pension reforms would lead to higher formal labour market participation or increased economic growth proved to be excessively optimistic. Finally, the policies laid out to fund the transition costs were either politically unfeasible (i.e. cutting pensions payable from the PAYG system in Poland) or insufficient for covering the expenses of the several-decade-long transition (i.e. privatization in Slovakia).

Debt financing proved to be a major implicit option among all the reformers. In fact, a large part of the pension contributions towards individual accounts were invested into government bonds that had been issued to finance the costs of pension privatization in the first place. This mechanism – that circuitously returned funds to the government while still meeting its obligations – was most extreme in Poland, where approximately 70 per cent of pension fund assets were invested into either state bonds or privatized state owned companies (Bielecki, 2011). It became more problematic to rely on debt financing after the 2008 financial crisis.

The importance of the funding gap problem was catalysed by the financial crisis. This was evident in a 2011 pension privatization reform implemented in the Czech Republic. In contrast to previous efforts, this legislation is specifically designed to avoid a funding-gap crisis. The reform includes a smaller second pillar, however it is voluntary, and those who subscribe must pay an additional contribution. The 2011 Czech reform plan intended to cover transition costs by raising VAT. At the same time, spending cuts (including first pillar pensions) were pursued. It is thus impossible to distinguish between financing through higher VAT and austerity measures.

The political economy of post-2008 reforms

The financial crisis that impacted Eastern Europe after 2008 reduced the fiscal space for CEECs (see Myant and Drahokoupil, 2012). Public deficits and demands on state spending increased as revenues fell. However, the change in pension privatization policies cannot be fully attributed to this 'exceptional fiscal circumstance' (as in Beblavý, 2011). In truth, the economic crisis was one of several factors that contributed to the transformation of the political and economic context surrounding these reforms.

Even before the financial crisis hit the region, it was obvious that pension reform was an unprecedented burden on public finances. The fiscal freedom to manoeuvre had been significantly limited before the crisis due to the Maastricht Criteria. This limitation was particularly stinging after the EU rejected the attempts of CEE member states to exempt the transition costs of private funded schemes from the Criteria. Maastricht obliged new member states to keep their public deficit and public debt under 3 per cent and 60 per cent of GDP, respectively. Eurostat clarifies, that as of 2007, debt stemming from the funding gap must be counted as a part of public debt (Eurostat, 2004). It should be noted though, that the European Council ruled in 2005 that transition costs will be partially exempted from the Maastricht debt criteria for a short transitory period only (EC, 2005, Art. 3.4).

Moreover, the World Bank changed its view on pension privatization. The Bank's active promotion of pension privatization had a major influence on the first wave of reforms and constituted an important base of political support for reformers (Müller, 2001; Orenstein, 2008). However, consensus on the issue within the bank had already begun to unravel before the crisis. By 2008, its pension privatization advocacy campaign was effectively over (Orenstein, 2011). The move was similarly echoed at the International Monetary Fund (IMF), which also stopped promoting pension privatization in its assistance programmes after 2008. The IMF went even further, providing tacit support to decisions to scale down and even close second pillar systems in countries that relied on the Fund for financial assistance.

These moves signified a broader shift in the overall discipline that followed the first wave of pension privatization reforms. The first wave of reforms, spurred by the World Bank, stimulated a learning process in both international policy making networks and among experts in CEECs. The propositions of the *Averting the Old-Age Crisis* were subjected to a wide range of criticism (e.g. Barr, 2000; Fultz and Ruck, 2000; Orszag and Stiglitz, 2001) and as a result, it became less common among experts to make assumptions about the growth-stimulating effects of funding. No longer was pension privatization seen as a solution to demographic aging or was assumed to have automatic growth-stimulating effects. In CEECs, the issue of first pillar stabilization in pension privatization became a significant part of debate, which had not been the case in the first wave of reforms.

Finally, the maturation of the first wave of CEE reforms contributed significantly to the learning process of pension privatization. New data made it possible to evaluate the performance of pension funds in terms of their rates of return, fees charged, and investment strategies. This maturation also exposed the unresolved problem of transition costs. This problem could no longer be ignored, as sizeable austerity measure seemed required to continue financing these reforms.[10]

The new circumstances, such as the withdrawal of the WB from the privatization agenda, changed the politics of pension privatization, making it essentially a domestic affair. However, the reforms in CEECs reacted to the legacies of earlier choices, namely the unresolved financing of transition costs. The combination of the tougher fiscal environment and the growing transition costs prevented further deferring of these debts. Dealing with the funding gap thus became a matter of distributing the costs in the short-term.

The actual solutions to this dilemma were the result of both fiscal constraints and political conditions. Countries with high constraints faced little option other than to scale down (temporarily) the second pillar. The policy towards the pillar, however, also reflected political factors that came into play when fiscal constraints allowed for more room to manoeuvre.

Economic constraints

As discussed, the fiscal constraints on the second pillar resulted from a combination of economic and political factors. These included the ratio of the funding gap to the budget deficit and whether governments had the ability – or willingness – to cover the latter through new debt or immediate spending cuts. The issue became a matter of vital importance in the aftermath of the 2008 financial crisis. The crisis created to a noticeable drop in revenues, which in turn led to increasing deficits in the budget and the pension account. The fiscal strain eventually pushed second pillar reforms onto the agenda as these contributions amounted to a substantial revenue loss. The increasing pressure on national budgets only compounded the growth in indebtedness. Given these circumstances, it is hardly surprising that the CEECs came to see the funds accumulated in the second pillar as a large source of potential revenue that could help balance the budgets, or repay the debt.

With the exception of Hungary, levels of indebtedness in CEECs were modest. Despite the fact that there were no problems with financing public borrowing these governments still faced growing deficits. Following a trend all over Europe, the Czech Republic, Slovakia (2010), and Poland (2011), all chose to pursue austerity policies to address the problem (Myant, Drahokoupil and Lesay, forthcoming).

In Hungary, the funding problem was dealt with in a different manner. The country was particularly vulnerable to the crisis due to its dependence on credit from abroad. As a result, the government experienced significant problems in financing its debt after October 2008 and was forced to request funding from the IMF and the EU. These economic constraints were decisive for the decisions to *de facto* nationalize the second pillar in 2010. This allowed the government to stabilize finances through revenue increases – the one-off transfer of accumulated assets amounted to 10 per cent of GDP. This influx helped to balance the budget at a delicate time when the government had decided to terminate a stand-by agreement with the IMF.

The decision to *de facto* nationalize the second pillar could be interpreted as a consequence of political change: Fidesz – a long-term opponent of pension privatization – took power after gaining an overwhelming majority in the May 2010 elections. However, fiscal conditions had made pension nationalization popular on both sides of the Hungarian political spectrum. The first proposal of this kind came from an eminent former central banker, György Surányi, who was being considered at the time as a potential prime-ministerial candidate for the Socialist Party in 2009. Moreover, the idea had already been contemplated in the ministry of finance during the socialist government of 2006-2009.

The need to balance the budget was also pressing in Poland, which – along with a somewhat higher level of indebtedness – faced regulatory constraints on increasing public debt. The government agreed with the EU to reduce its budget deficit to approximately 2 per cent of GDP by 2012. Moreover, self-imposed restrictions triggered penalties if public debt crossed the 55 per cent level. The decision of the ruling party PO to scale down the second pillar was primarily motivated by immediate budget constraints (cf. Naczyk, 2010; Rae, 2011).

In Slovakia, financing the transition costs had also contributed significantly to increasing indebtedness, but the country did not face such constraints that would impose a need to balance the budget immediately. Its debt-to-GDP ratio was a healthy 40 per cent. Moreover, Slovakia's economy appeared to have quickly returned to growth. After a 4.9 per cent contraction in 2009, the country experienced 4.2 per cent growth in 2010.

New politics of pension reforms

The end of the WB's privatization campaign, coupled with the learning processes following the maturation of the first wave of reform, changed the politics of pension reform in CEE. The economic and regulatory constraints limited the funding of transition costs through debt. However, these setbacks did not represent the 'death' of the privatization agenda. The withdrawal of the WB from the pension privatization agenda had made pension privatization a matter of domestic politics. The respective decisions made by national governments regarding the second pillar were thus determined by the ideology of the ruling party. As coalition governments were typical in CEECs, the coalition composition similarly shaped the eventual policy output.

Party positions on pension privatization became structured by the left/right divide – defining the position towards decommodification and redistribution – and the conservative/liberal dimensions – shaping the position towards the role of the state in directly intervening in the economy and society (see Table 3). Left-wing parties preferred policies that allowed for decommodification and redistribution. Liberal parties pursued reducing the role of the state in favour of market relations. Pension privatization thus became an agenda of the liberal right.

The post-2008 reforms were therefore a result of both economic constraints and cabinet ideology. (An overview of the conditions and outcomes is provided in Table 4.)

Although party ideology and coalition politics were also important determinants in the first wave of pension privatization, the left-right dimension was far less prominent (see Armeanu, 2010; Guardiancich, 2011). This can largely be attributed to the fact that in most CEECs a solution to financing the funding gap was deferred to future in the first wave of reforms, In the first wave, the information about the actual costs and benefits of these programs was poorly distributed due to the numerous reform 'myths' (Barr and Diamond, 2008; see Barr, 2000). These myths, such as that funding resolves adverse demographics, also contributed to the conflation of the problems of pension privatization and stabilization of PAYG systems. As financing through debt became more difficult – and the actual costs of pension privatization became less obfuscated – the funding of transition costs became an immediate distributional issue.

Liberal right-wing parties continued to support pension privatization after 2008. Funding transition costs through spending cuts also fitted with the ideology of reducing the size of the state. As such theses parties tended to support reforms that: individualized insurance against old-age risks; increased the scope for markets in old-age insurance; and dismantled redistribution through the pension system.[11] Increasing VAT thus seemed to be the tax increase of choice for these right-wing parties. However, liberal-right ideology is ambiguous on the desirability of a compulsory second pillar as the obligation to take insurance infringes upon individual choice. A compulsory system can also imply an implicit state guarantee for the second pillar pensions. Given this ambiguity, the considerable costs of the reform were likely to generate splits on the right as funding obtained through spending cuts and tax increases also threatened re-election prospects. The more pragmatic centre-right parties eventually accepted a more modest second pillar than was common in the first-wave of reforms.

Coalitions of centre-right and liberal-right parties shaped reform outcomes in Slovakia and the Czech Republic. The Slovak government reacted to the need to confront the funding gap by proposing to finance the second pillar through spending cuts – in particular by reducing first-pillar pensions. In the Czech Republic, an exceptional majority won in the 2010 elections and allowing right-wing parties a reform breakthrough. In this case, their concern with the ability to finance the funding gap led to reform that involved a more modest and voluntary second pillar, funded through VAT increases and spending cuts – also in the first pillar.

Conservative-right parties, in contrast, were more likely to oppose a second pillar, particularly if confronted with the financing of transition costs. They saw little value in expanding the scope for the market since it reduced the power of the state in directly influencing distributional outcomes. Conservative-right ideology at the time did not favour redistribution from higher-income groups, but preferred to directly influence the degree of decommodification as allowed by the parametric reforms of the first pillar.

As discussed earlier, the conservative, right-wing Fidesz came to power in Hungary after its landslide victory in 2010 and implemented a *de facto* pension nationalization. The Polish Law and Justice party (PiS) was in opposition, but it too put forward a proposal for making the second pillar voluntary with similar implications (see Rae, 2011).

Left-wing parties, both liberal and conservative, should have opposed privatization as it commodifies pension insurance and dismantles redistribution through the first pillar. The position of left-wing parties on pension reform was ambiguous in the first wave (cf. Armeanu, 2010), with the left actually pursuing privatization in Hungary and Poland. Left-wing ideology also tended to oppose any pension cuts in the first pillar despite the fact that these cuts have provided major source of revenue to fund transition costs. This can be attributed to poor information about the actual implications of pension privatization models and transition costs. As the first-wave reform matured and the information about its costs and benefits became more widespread, it became more apparent that privatization could not solve the imbalances in the first pillar or deliver higher pensions.

The strong power of the left and the unions caused the three-pillar model to disappear from the political agenda in Slovenia after the failed reform of 1998. In Slovakia, the Smer government of 2012 scrapped the reforms of the 2010-2012 right-wing government and planned a downsizing of the second pillar. Finally in the Czech Republic, social democrats have mobilized against the pension privatization promising to reverse such reforms after they take power.

Conclusion: What future for pension privatization?

A diversity of pension reforms characterized the period after 2008, but some common features defining a new privatization agenda can be identified. These can be broadly defined in three categories:

First, the new political economy surrounding these reforms does not allow the deferral of costs to the future. A much more modest second pillar, financed by about 3 percentage points diverted from the first pillar, seems to be a maximum that is politically feasible in CEECs. Liberal-right wing parties have thus faced electoral constraints by the imposed limit on spending cuts and tax increases implied in financing second pillars. In the Czech Republic and Poland, proponents of reform have apparently accepted such a point of view. The political feasibility of the Slovak right-wing reform proposal was never tested. The cuts were anyway scheduled for later periods.

Second, the reforms that followed the 2008 financial crisis exposed the political risks of prefunded schemes. The Hungarian example demonstrates that accumulated funds can be effectively nationalized. The risk of such nationalization can be correlated with the volume of funds accumulated on pension accounts on the one hand, and the narrowness of fiscal space on the other. The latter will certainly grow in coming decades and the likelihood of the former increasing is similarly high. The evidence shows that a formalized cross-party consensus on pension privatization during the first wave of reforms could have potentially counterbalanced future political risks, but such consensus was lacking in CEECs.

Third, although pension privatization programs have clearly lost much of their initial appeal in the region, this should not be taken as their final defeat. As Orenstein (2011) discusses, a rebirth of privatization in a different form is possible. This is evidenced by a shift among the privatization proponents who are now less likely to extoll the virtues of the second pillar as a solution to demographic aging. Instead, ideological and social justice arguments became more prominent (e.g. reducing the role of the state, creating property rights, reducing redistribution). Risk diversification appears to be the main macro-economic argument proposed in favour of the multi pillar system. Several opponents of the second pillar are thus still in favour of the third pillar. This suggests that the reform reversals of the past few years may yet lead to the strengthening of the private component in the pension-policy mix via the third pillar.

Tables and figures

Table 1 Pension reforms in Eastern European EU member states

Country (year of privatisation)	**Pre-2008 situation** System characteristics (total old-age pensions contributions as % of wage, contributions to the second pillar)	**Main reform tendency after 2008**	**Post-2008 reforms**
Bulgaria (2002)	Three-pillar pension system (22% for regular employees, 5%). Joining second pillar is open for workers born after Dec. 31 1959.†	- Partial nationalization of vocational pension funds -Increase of contribution rates -Increase of retirement age	1.8% points (pps) increase of PAYG contributions; 2 pps increase of second-pillar contributions Gradual increase of retirement age from 63/60 for men/women to 65/63 Gradual increase of years of contributory service to 40/37 for men/women 20% of private vocational pension funds (worth BGN 100 million) directed under state control
Czech Republic (2013)	PAYG system (28%, 20% of which are old-age pension contributions) complemented by third-pillar	Moderate pension privatization	Voluntary second pillar 3 pps transferred from pension contributions + and 2 % of gross salary as additional contribution
Estonia (2002)	Three-pillar system (22%, 6%)	-Raising retirement age -Temporarily redirecting contributions to first pillar	Gradual increase of retirement age to 65 in 2026. Diverting employers' contributions to first pillar in 2009 and 2010; 3% contribution level to second pillar in 2011 and 6% in 2012. Decreasing employees' social security contributions is also possible. In this case, the decrease will have to be compensated by larger contributions later.
Hungary (1998)	Three-pillar system (33.5%, 8%)*	De facto nationalization of second pillar	Downsizing of the second pillar in favour of the PAYG system in 2010 Private-pension-funds members could choose between moving their savings to the state-funded system or remaining in the private system. with the latter option being disadvantageous. Transferring to state-run system a default option 2011: members of second pillar will, as of 2012, pay all their compulsory contributions to the state-run system; Second pillar ceases to exist
Latvia (2001)	Three-pillar system (20%, 8%)	- Covering pension costs by cutbacks - Directing contributions towards 1st pillar	Contributions to second pillar reduced from 8% to 2% in May 2009; Amendments: contributions to second pillar remained at 2% until 2012, expected to rise to 6% by 2014 First pillar benefits cut Stricter rules for early retirement
Lithuania	Three-pillar system (23.7%,	Redirecting pensions	Contributions to second pillar reduced from 5.5% to

(2004)	5.5%)†	towards first pillar	2% in 2009 and 2010, 2011: contributions stay 2%; contribution rates decrease to 1.5% in 2012; rest is redirected to the first pillar
Poland (1999)	Three-pillar system (19.52%, 7.3%)	Part of payments redirected from second to first pillar	March 2011: contributions to second pillar decrease from 7.3% to 2.3%; 5 pps redirected towards first pillar. Increase of second-pillar contributions to 3.5% expected by 2017
Romania (2008)	Three-pillar system (29%, 2%)*†	Attempts to decrease pensions.	2010, pensions were to be decreased by 15%, but ruled unconstitutional Retirement age to be increased from 58y9m/63y9m for men/women to 60/65 by 2014, to be brought to 65 for everyone by 2030
Slovakia (2005)	Three-pillar system (18%, 9%)	Attempts to further liberalize	Voluntary participation in second pillar, enrolment as a default option State guarantees kept for the most conservative investment funds only
Slovenia	PAYG system (24.35%)*	Attempts to increase retirement age	No legislative change possible due to a referendum in June 2011 (increases in retirement age to 65 years and a stronger equivalence proposed)

**Includes contributions for permanent disability and/or survivors' pensions.*
† State of pension scheme as of 1.1.2008.

Table 2 The funding gap in Hungary, Poland and Slovakia, 2009-2010 - % of GDP

Country	Funding gap 2009 (as % of 2009 GDP)	Funding gap 2010 (as % of 2010 GDP)	Amounts of pension contributions diverted to the second pillar(as % of 2010 GDP	Financing solutions proposed during first-wave reform
Hungary	1.39	1.09	9.54	Expectation of increased economic growth and employment
Poland	1.59	1.89	11.59	Reforming the first pillar and privatizing state property
Slovakia	1.24	1.24	6.20	Special fund worth 4.38% of 2005 GDP; a reserve fund with contributions of 4.75% salary

Sources: authors' own calculations based on data from the Hungarian Financial Supervisory Authority (http://www.pszaf.hu/en/) and the Hungarian Central Statistical Office (http://www.ksh.hu/; Concise Statistical Yearbook of Poland 2011, Polish Financial Supervision Authority (http://www.knf.gov.pl/) the Slovak Ministry of Labour, Social Affairs and Family (http://www.employment.gov.sk/), the Statistical Office of the Slovak Republic (http://portal.statistics.sk/showdoc.do?docid=359), and the estimate of the Slovak Ministry of Finance.

Table 3 Party ideology and expected preferences towards pension privatization

Decommodification/redistribution

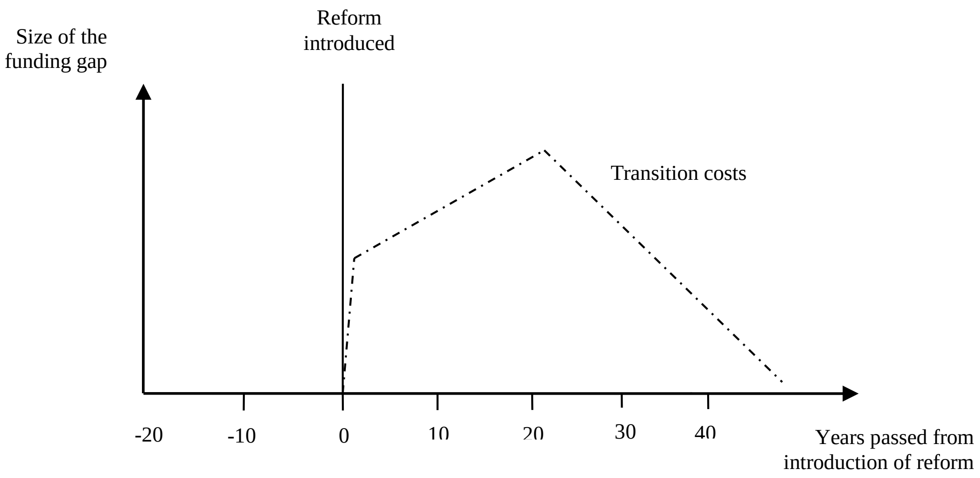
State control		Right	Left
	Conservative	Against (previously more ambiguous) *Fidesz (Hungary), PiS (Poland)*	Against *Smer (Slovakia), KSČM (Czech Republic)*
	Liberal	Supports privatization Likely to accept a more modest pillar *ODS, TOP09 (Czech Republic), PO (Poland)*	Against (previously more ambiguous) *ČSSD (Czech Republic), MSZP (Hungary), SLD (Poland)*

Political parties characterized by respective ideological positions in italics, Slovenian parties not displayed as the three pillar model is not on the agenda in the country.

Table 4 Averting the funding gap crisis: Determinants of reform trajectories in CEECs after 2008

	Economic constraints		Political factors	Reform outcome
	Debt level & financing	Funding gap	Coalition composition	
Czech Republic	Low	0	Centre right and liberal right government (strong majority from 2010)	Pension privatization, modest and voluntary second pillar; Funding through taxation and spending (notably through first-pillar pensions)
Hungary	High	High: no prefunding	Conservative right gains exceptional majority	De facto nationalization
Poland	Medium	High: no prefunding	Centre right and a farmers' party	Downsizing the second pillar; Funding through spending cuts an implicit option
Slovakia - until Oct 2011	Low	Medium: pre-funding through privatization and a reserve fund	Centre right and liberal right	Proposal to fund the second pillar through spending cuts (notably through first-pillar pensions)
- from 2012			Conservative left strong majority	A 'comprehensive reform' promised
Slovenia	Low	0	Left-liberal (until Dec 2011)	Second pillar not considered

Figure 1: The development of the funding gap



Based on Simonovits (2003: 156)

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[2] The CEECs include the Czech Republic, Hungary, Poland, Slovakia, and Slovenia. This analysis draws on interviews with policy makers in CEECs conducted in 2011-2012 and publicly available data.

[3] In the WB model, the first pillar was supposed to provide a flat subsistence pension, but none of CEECs implemented the pure WB model.

[4] The second pillars survived also when their political opponents took power. In Hungary, the coalition led by the conservative right-wing Fidesz took power only six months after the three pillar model was introduced by the social democrats. The government stopped the planned increase in the second pillar contributions rates from 6 per cent to 8 per cent of gross wage, but it did not reverse the reform. In Slovakia, when the opponent of pension privatization, the social-democratic party Smer took power in 2006-2010, it implemented only minor changes in the regulation of the second pillar. In Poland, the government of the Democratic Left Alliance (SLD), a party that voted against privatization in 1999, did not reverse the reform when it took power in 2001, nor did the conservative-nationalist coalition government led by the Law and Justice Party (PiS) from 2005.

[5] Let us assume an economy where, from a given year, the mature PAYG system has been entirely replaced by a fully-funded system available for the younger part of the workforce. Once the last cohort relying on purely the PAYG pillar dies the fully funded system becomes a mature pension scheme. In this hypothetical example, the pension reform would cease to produce a growing funding gap in the year when the first such cohort enters retirement that relies for its pensions on the funded scheme exclusively.

[6] This perspective has been prominent also among policy makers supportive of the second pillar whom we interviewed in 2011-2012.

[7] These conditions include: savers should not stop saving as a reaction to the new policy; savings on individual pension cannot be allocated into newly issued national governmental bonds; the funds should not be invested abroad or into commodities (Barr and Diamond, 2008).

[8] The minister of finance thus joined the labour unions in opposing the failed 1998 pension privatization proposal.

[9] These projections were based on an optimistic macroeconomic scenario counting on the positive influence of new pension legislation on labour participation and increased economic growth due to more capital.

[10] In this context, the circular transaction in which state debt issued to cover transition costs was financed by the pension funds attracted attention in Poland and Hungary where it was particularly important (e.g. Cienski, 2011).

[11] It should be noted that a PAYG systems organized purely on the NDC principle does not redistribute either.