Downsizing of private pension pillar

Given the demographic challenges, reliance on the PAYG system implies lower benefits for pensioners, a need to increase social contributions or retirement age in the future. As a decision is needed in a matter for decades rather than immediately, the government is focused on maximizing current consumption through fiscal easing increasing contingent liabilities.

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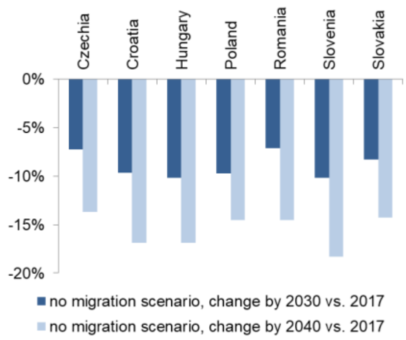
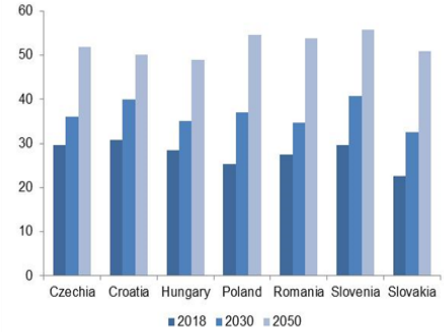
The introduction of private pension schemes in the late 1990s and early 2000s was aimed at enhancing pension savings and reducing reliance on state pension schemes. Inflow of social contributions would fall short of financing a growing number of retirees in face of the shrinking working age population. In most cases, contributions to private pension funds were carved out from contributions to mandatory pension systems, frontloading the costs on expense of current fiscal balances. While the Pay As You Go system (PAYG) was kept alive, its role was to be reduced over time and the pension entitlements from the private pillar were supposed to replace part of the PAYG. The new scheme, with all its flaws, such as high management costs or portfolios inadequately adjusted to life cycle, was supposed to address the demographic challenge, be less prone to political intervention and assure high enough pension savings for future generations, as the old-age dependency ratio is expected to double within 30 years. In other words, in a few decades there will be twice as many elders per 100 working persons. Relying on the PAYG system would thus imply either lower benefits for pensioners (lower replacement ratio or indexation of pensions), higher social contributions paid by the working population, or increased retirement age.

Shrinking working age population



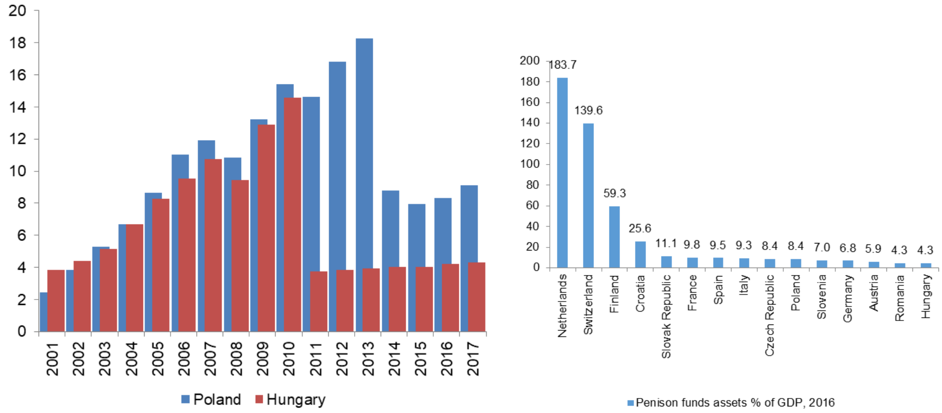
Projected old-age dependency ratio



Source: Eurostat, Erste Group Research

The first country to introduce the private pension system, Hungary, was also the first to dismantle it in the aftermath of global financial crisis that exposed the Hungarian government to a difficult situation – a need to consolidate during the downturn. First, the global recession revealed the extreme sensitivity of pension funds to financial market volatility and exposure of the pension assets to the recent financial market performance. Further, the transition costs of the pension reform burdened public finances and the global recession only challenged their sustainability. Fiscal austerity and need for deficit reduction became an excuse for governments to dismantle the private pension system.

Change and comparison of pension funds' assets (% of GDP)



Source: OECD, World Bank, Erste Group Research

In 2010, Hungary diverted the private pension funds contribution back to the state and seized the assets of pension funds. In Poland, the downsizing of the private pension pillar was carried out in a couple of steps. First, the government bonds held in portfolios of pension funds were transferred to PAYG and exchanged for inflation-linked deposit (unfunded) at virtual accounts in the social security system. Now, the rest of the funds held mostly in equity are to be transferred either to individual pension accounts at a 15% fee or to virtual accounts in the social security system. The most recent change serves the purpose of financing election induced fiscal stimulus that would otherwise put public finances under pressure. The drawback of this solution is that the government increases contingent liabilities which will be due at the most difficult time, when ageing-related costs will put enormous pressure on public finances.

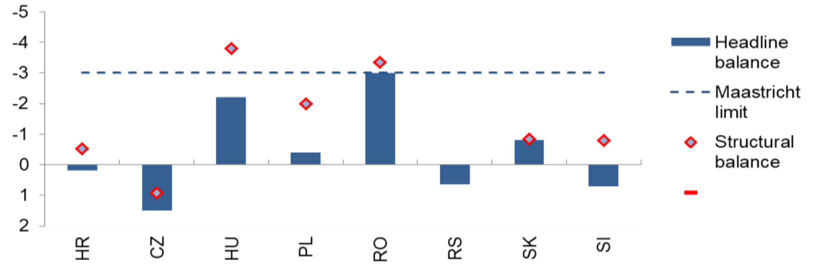
Box 1: How (not) to do fiscal easing

The fiscal stimulus in Romania (increase in public wages, VAT cuts) boosted the economy, but put the headline budget deficit just shy of 3% of GDP in 2017. The fiscal adjustments seem to be questions of 'when' and 'how', as Romania's public finances remain fragile. The risk of Romania exceeding the limit of 3% in 2018 and/or 2019 remain considerable. It would put Romania under the Excessive Deficit Procedure (it is currently under the Significant Deviation Procedure together with Hungary, due to high structural deficits).

Hungary is about to announce fiscal easing in the weeks to come. Despite a structural balance well above MTO, the headline deficit is visibly below the limit of 3%. Slovakia seems to be next in the "fiscal easing" line, with proposals to lower taxes, increase the minimum wage or extend maternity benefits. A significant deviation from MTO results in more severe consequences in the case of Slovakia, as a Eurozone member (even a 0.2% GDP penalty).

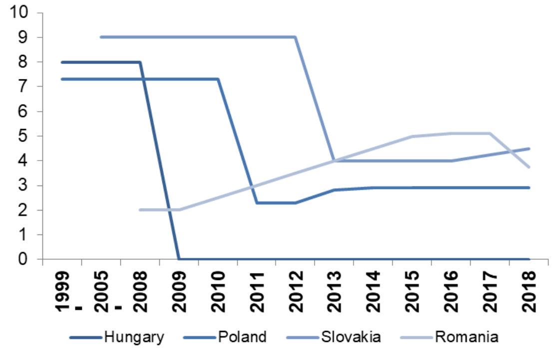
Due to the upcoming elections, Poland showed all its cards. Financing the generous fiscal package without breaching the 3% deficit limit was questionable until the government revealed plans to overhaul the pension system. Dissolving Open Pension Funds (along with improvement in collection of taxes and social contributions) will generate a budget surplus in 2020, accoridng to the latest stabiltiy and convergence program. All in all, public finances should remain in good condition, with lower borrowing needs and a downward trend in public debt, at least in the short term.

Fiscal position, % of GDP, 2018



Source: Eurostat, AMECO, Erste Group Research

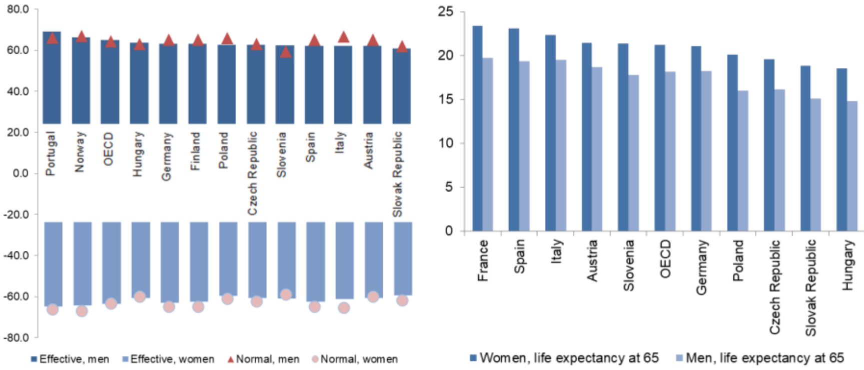
Development of contributions to the private pension system



Source: Erste Group Research

In Romania, the private pension system was introduced at a relatively late stage (2008). It is based on three pillars: PAYG, mandatory second pillar and voluntary third pillar. It underwent changes only recently, facing sector taxes, increase in capital requirements and capping the fees for pension funds or the possibility to invest in PPP. It also opened up the opportunity to leave the system. Slovakia has a similar structure for its pension system. Slovakia faced a reduction in contributions to pension funds, similar to those seen in Poland in the first phase but began to raise them in 2016, while in Romania contributions have been gradually growing until 2018. Moreover, as an aftermath of global financial crisis, regulations required the sale of almost the entire equity portfolio, which resulted in the booking of huge capital losses and cut off pension funds from being able to participate in the recovery of equities, as all funds had to be invested only in instruments with low volatility (fixed income products).

Effective retirement age and life expectancy at 65



Source: European Commission, AMECO, CSO, Erste Group Research

On top of that, there is an increasingly worrying trend in CEE to reduce or cap the retirement age, even while life expectancy is increasing. In most CEE countries, the effective retirement age is in any case lower than the legal one. Women already retire in their 60s, which leaves them with another 20 years of life as a pensioner. Men work only few years more and could expect another 15 years of life. Increasing life expectancy will lead to growing healthcare costs, especially as the share of the population over 65 will keep rising in the decades to come. While in Hungary and Slovakia the net pension replacement rate is relatively high, at above 80% of net earnings, in Poland the ratio has been halved.

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