Case study of pension reform: Poland

Political Economy of Pension Reforms,
October 31st, 2019

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Pensions Core Course

Outline

1. Context: 25 years of economic transition in Poland

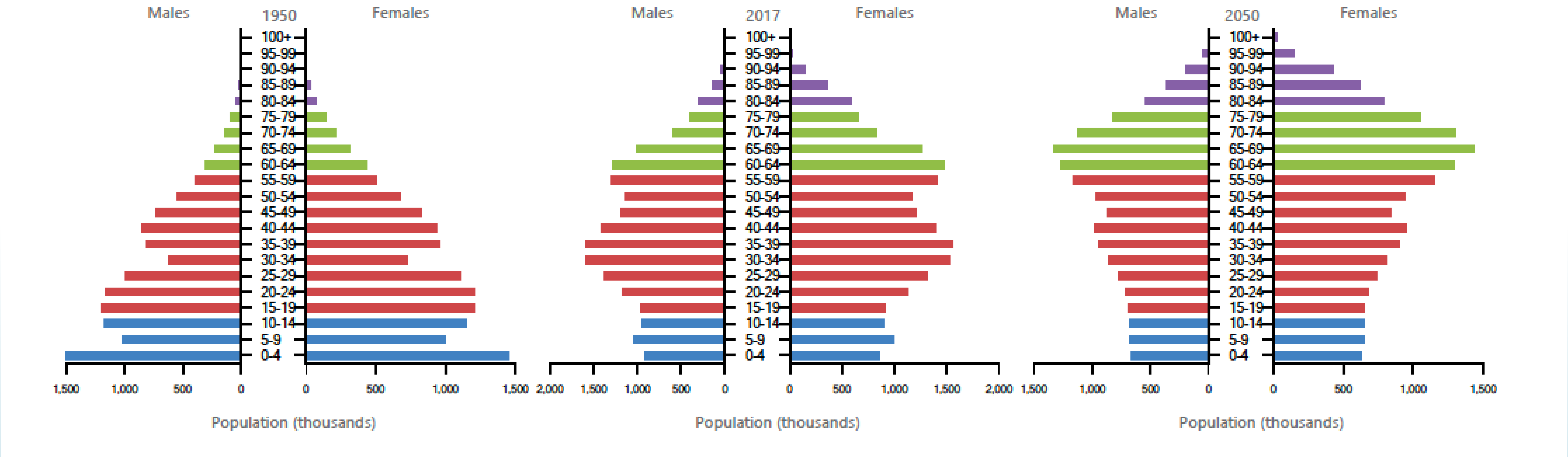
2. Evolution of the employees' pension system in Poland in the past 25 years

3. What next?

4. Lessons learnt

5. Farmers' pension system developments and challenges

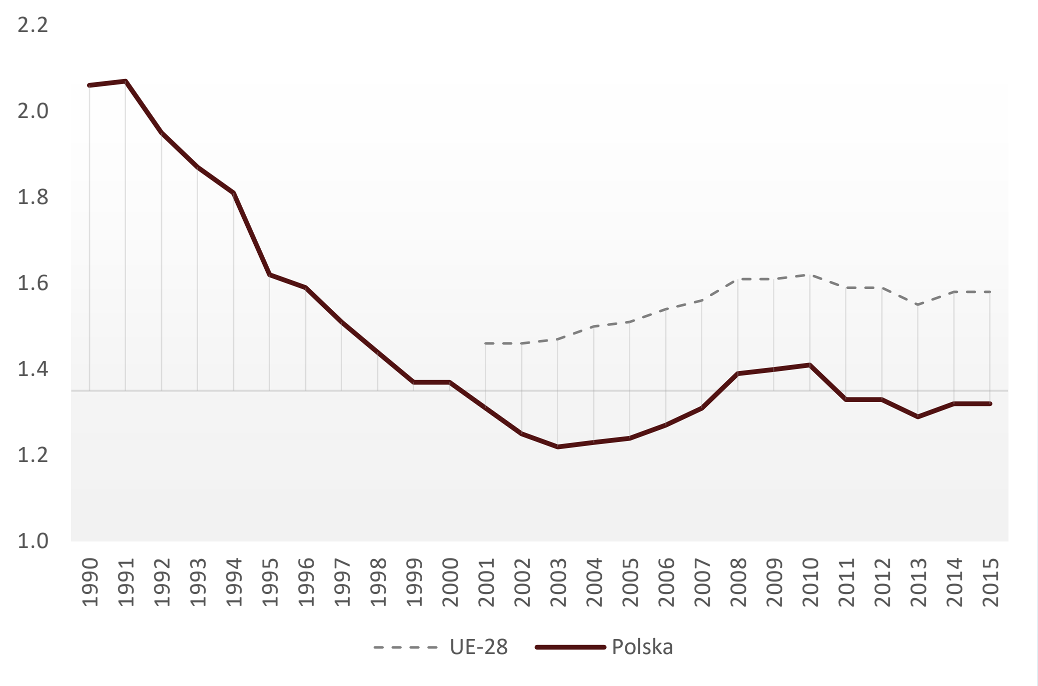
Changing age structure of the Polish population



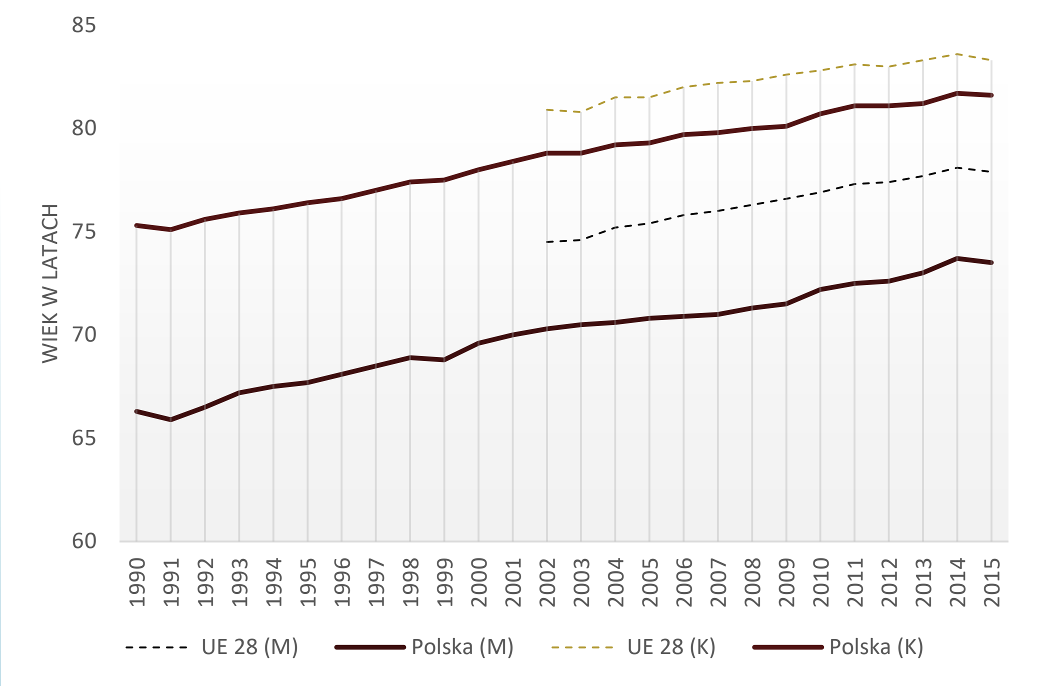
- https://population.un.org/ProfilesOfAgeing2017/index.html

Fertility remains low and life expectancy increases

Fertility rate: pl vs EU



Life expactancy: pl vs eu



EVOLUTION OF THE EMPLOYEES' PENSION SYSTEM IN POLAND IN THE PAST 30 YEARS

Stages of pension system changes in Poland

- Pension system in early 1990s: restoring adequacy
- Shaping the pension reform in Poland – „Security through diversity”
- 20+ years of reform implementation
- Pension system after economic and fiscal crisis

Pension system after economic transition

Pension system in early 1990s: restoring adequacy

1. Early retirement further widespread to absorb excess workers due to jobs destruction in the transforming economy
2. Level of benefits below adequacy due to high inflation level
   - recalculation (revalorisation) of all pensions in 1992
   - Introduction of permanent pension indexation anticipating inflation levels
   - New pension defined-benefit pension formula
     - linking pensions to individual wage level and employment history (1.3% of wage for each year of work)
     - redistributional part (24% of average wage)
3. New pension system for farmers – KRUS to maintain coverage and pension income among individual farmers
   - Benefits depend mainly on the number of years worked in agriculture

Need for pension reform in 1990s

Pension system in early 1990s: restoring adequacy

- Pension system development from early 1990s led to its unsustainability in long run:
  - Contribution rate: 45% of payroll
  - Replacement rate: 70-80% of wage
  - Average retirement age: 55 for women and 60 for men
  - Pension expenditure reached 14-15% of GDP in mid 1990s

- Problems in pension system:
  - Short-term: rising deficit, widespread early retirement, actuarially imbalanced
  - Long-term: population ageing caused by approaching retirement of baby-boom generation and falling sharply (to lowest-low) fertility rate

- Current adjustments to pension systems turned out to be ineffective, the pension reform became inevitable

Shaping the pension reform in Poland – „Security through diversity”

- The pension reform concept elaborated between 1996 and 1998
- The reform implemented in 1999
- Moving from mono-pillar PAYG DB system to
- Multi-pillar scheme:
  - Mandatory first pillar: non-financial defined contribution (12.22% of wage)
  - Mandotary second pillar: financial defined contribution (7.3% of wage)
  - Voluntary third pillar: employee pension plans, individual retirement accounts (2004), individual retirement protection accounts (2009)
- Coverage:
  - Mandatory NDC+FDC: born after 1968
  - Choice between NDC+FDC or NDC only: born between 1949 and 1968
  - PAYG DB: born before 1949

Shaping the pension reform in Poland – „Security through diversity”

- Projected reform outcomes:
  - Regaining financial stability in the long run: close to actuarially balanced pension formula
  - Transition costs financed from privatisation revenue, savings in pension system (limiting early retirement) and from the state budget
  - Incentives to postpone retirement decisions
  - Reduced generosity of pension benefits – towards actuarial fairness
  - Clear separation of redistribution and income replacement role:
    - Contributions for selected periods financed from the public funds
    - Minimum pension guarantee (top-up) financed from the state budget

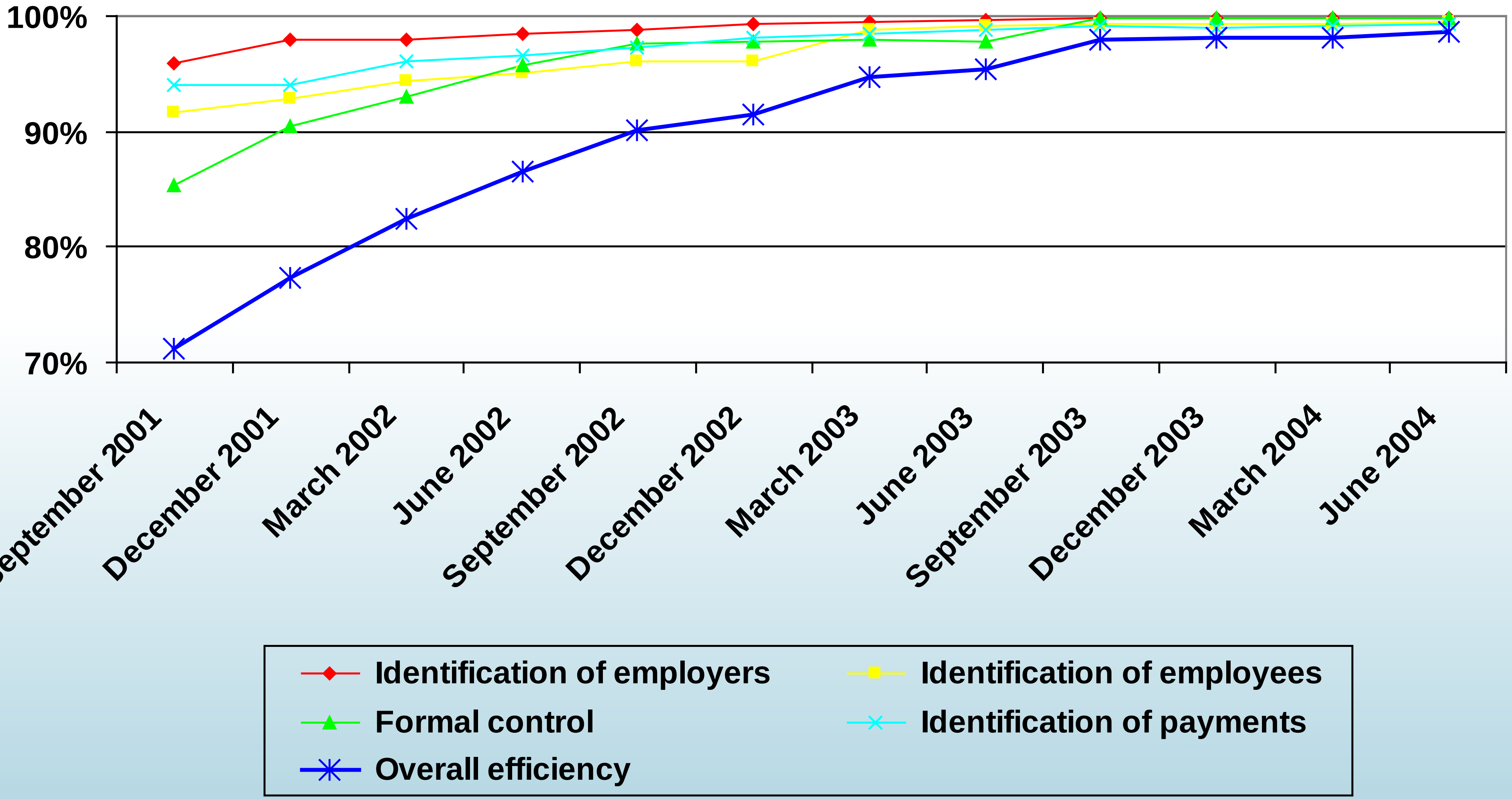
Implementation issues

- Introduction of the new IT system with delays
- Errors in individual contribution records
- Longer calculation of initial capital

- Administration is crucial for the smooth implementation of the pension reform

ZUS - Correctness of information

Shaping the pension reform in Poland – „Security through diversity”

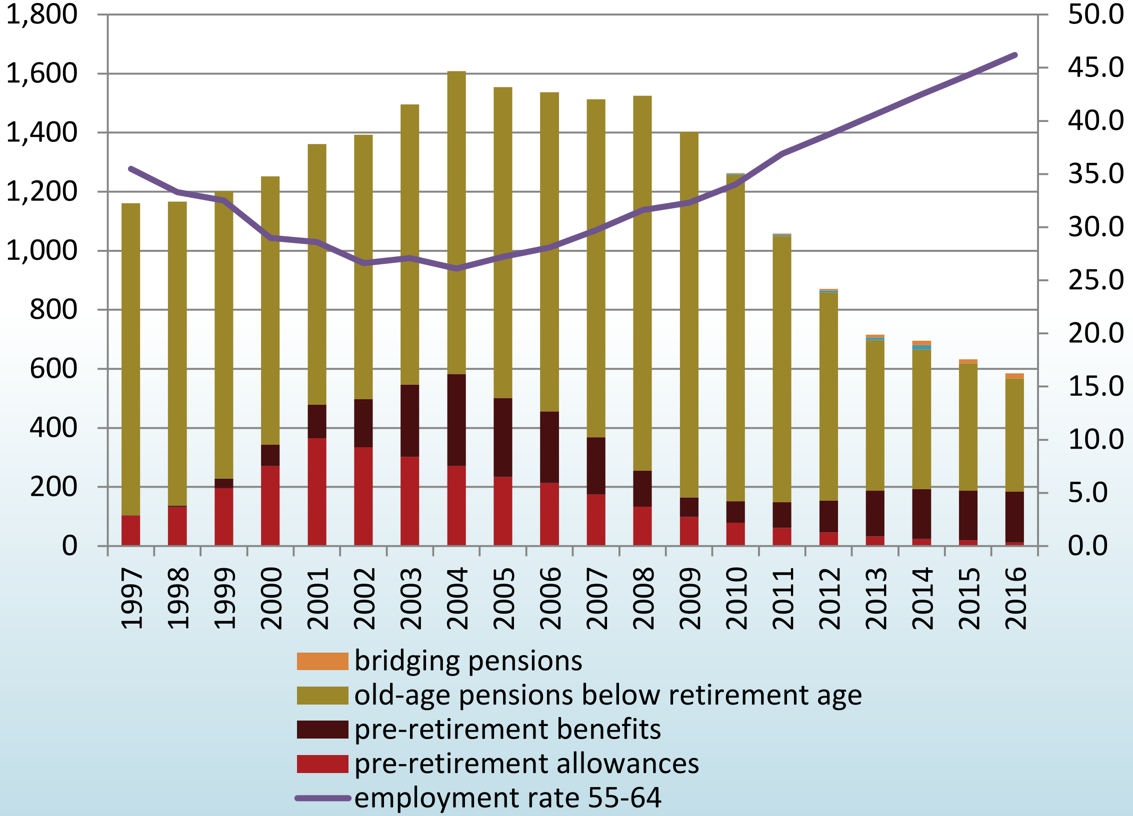


Source: ZUS

Early retirement struggle

20+ years of reform implementation

- The reform plan was to reduce early retirement
- During first years: early retirement expanded through pre-retirement transfers
- Possibility of early retirement extended from the end of 2006 till the end of 2008
- The final plan of „bridging pensions” introduced from 2009
- Quick reduction of early retireees and rise of employment rate

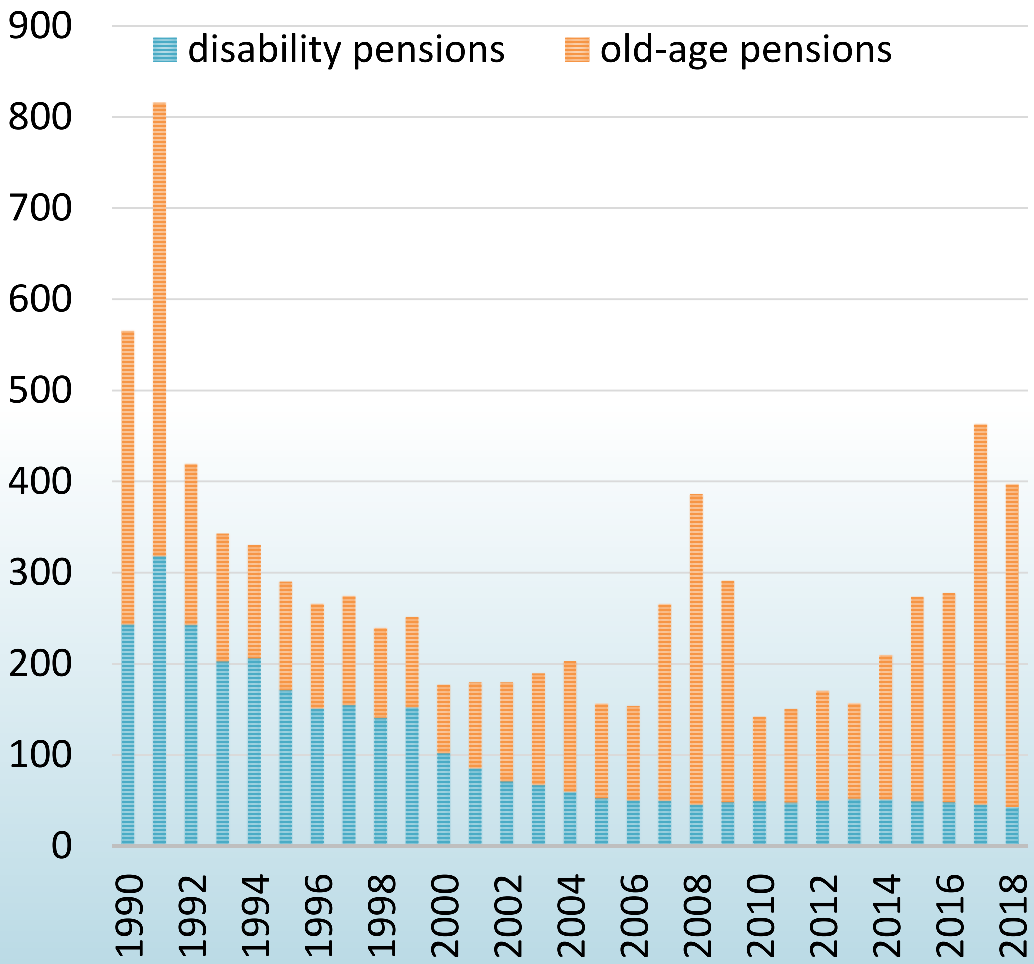


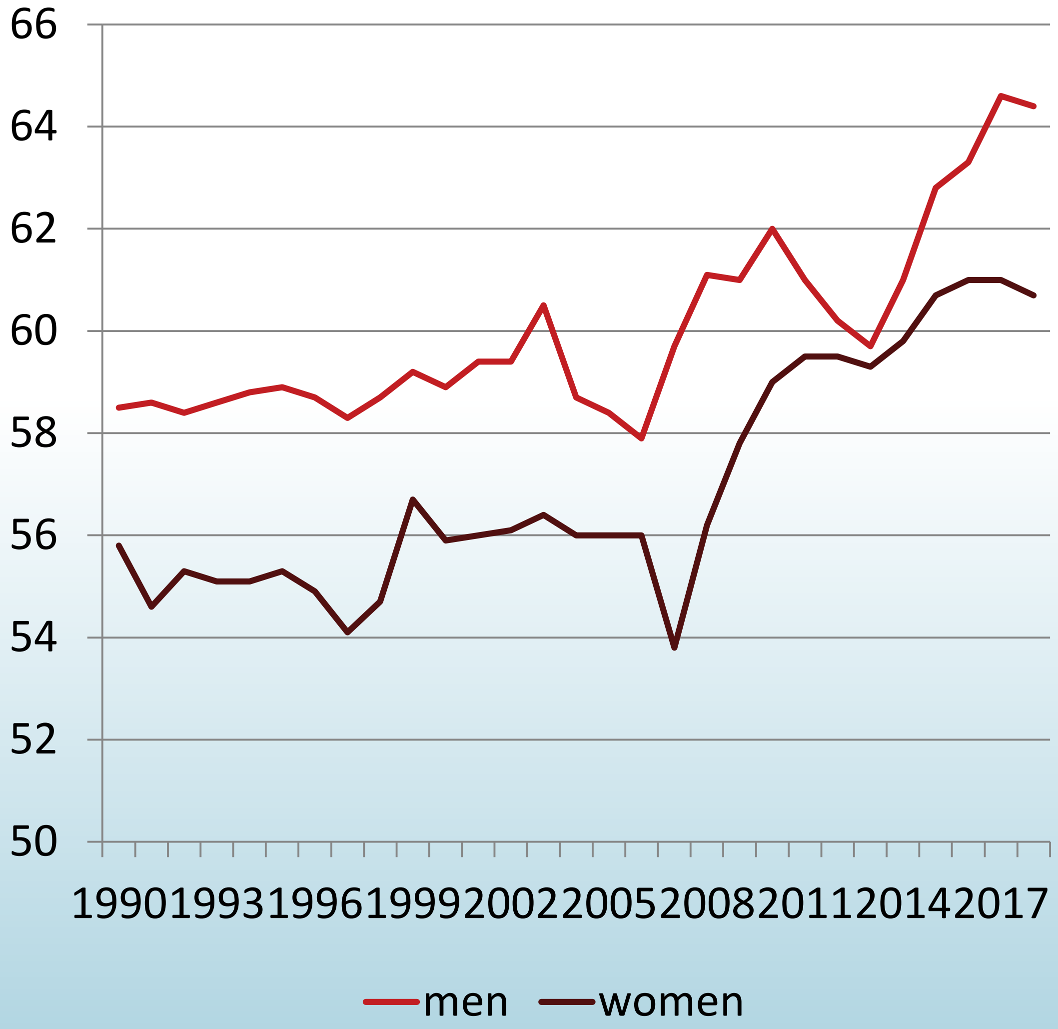
Retirement age

20+ years of reform implementation

- Traditionally different retirment age of men and women: 65 and 60
- Initial reform prop2013osal of equalising retirement age not supported by the politicians
- Gradual equalisation of retirement age to 67/67 approved from 2013
- In 2017 the raise of the retirment age reversed

Inflows to pension system and retirement age





Source: own analysis of social insurance data

The new pension system in Poland: implementation experience

20+ years of reform implementation

Initial plan:

- NDC + FDC operating from 1999
- Indexation of pensions close to CPI
- Diversification of FDC investment strategies from 2004
- Early retirement removed from 2007
- Transition costs financed partcially through removal of early retirement

Reality:

- Initial plans implemented, but some elements remained not solved (annuities, multi-funds)
- Indexation close to wage growth until 2004
- No diversification of FDC investment strategies
- Early retirement prolonged by two years, additonal early retirement rights for men granted in 2008
- Increased social insurance deficit due to reduction of disability contribution from 2008

Fiscal situation and reform reversal

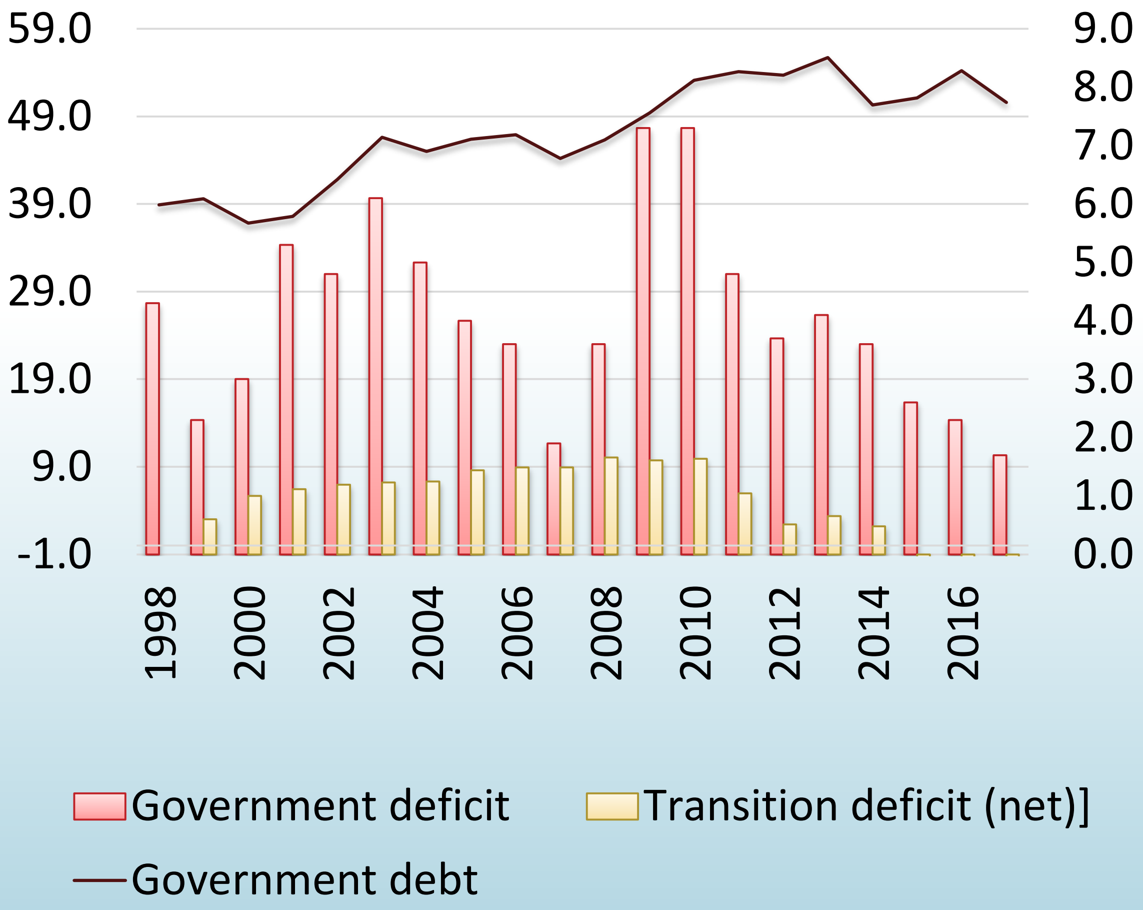
Pension system after economic and fiscal crisis

May 2011:

- Contribution rate to FDC reduced to 2.3% in May 2011
- 5% of wage recorded on quasi-NDC account (indexed to GDP growth)

February 2014:

- contribution at 2.92%
- assets invested in government bonds (9% of GDP) transferred to PAYG scheme and redeemed
- FDC parts opt-out and opt-in in specified time slots (first slot: April-July 2014, second in 2016
- assets from FDC transferred gradually to PAYG 10 years prior to retirement – net transfer from pension funds



Conseqences of the reversal

Pension system after economic and fiscal crisis

- Sustainability of public finance
  - In short run: public finance debt remaining below 55% of GDP
  - In long run: increased implicit pension debt and higher pension expenditure in the future, when demographic dependency rates worsen sigificantly
- Adequacy of pensions
  - Increased risk level (due to changed proportions of FDC and NDC)
  - Potentially lower returns (historically higher average returns in FDC and less investment in equity)
- Reduced role of pension funds as domestic institutional investors:
  - Potential impact on the volatility of the Warsaw Stock Exchange
  - Smaller involvment of pension funds on the primary market

Sustainability and adequacy of pension system as of today

- Reversal of pension reforms caused by a set of socio-economic factors, including most importantly
  - poor fiscal situation
  - rising pressure from current pension system expenditure
- Performance of pension funds had little impact on reversal decision
- Change in contribution split:
  - Increases the risk in the pension system
  - Potentially reduces future pension levels

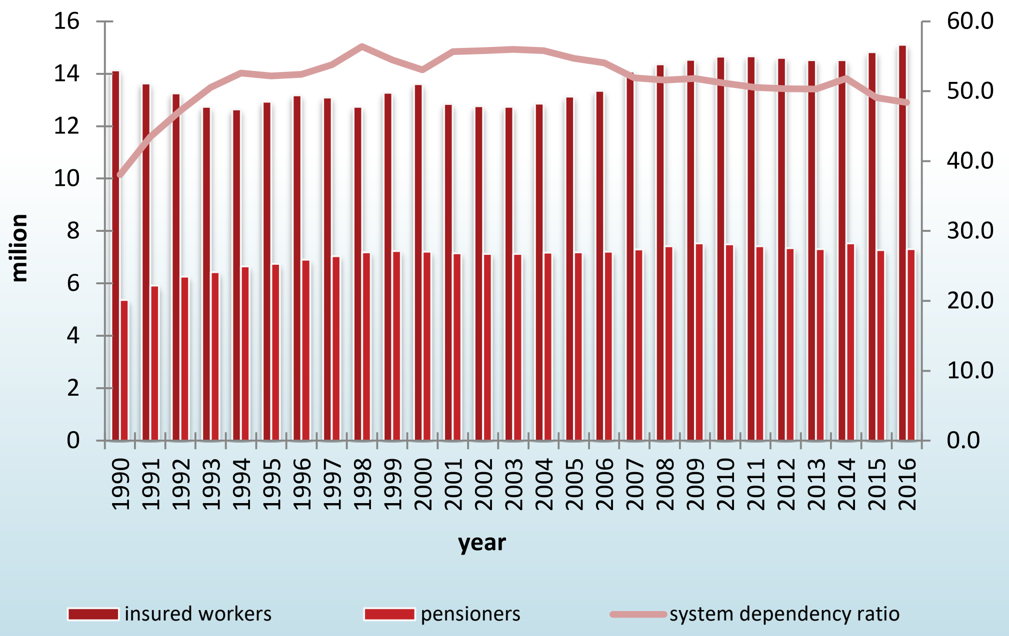
Sustainability and adequacy of pension system as of today

Pension system after economic and fiscal crisis

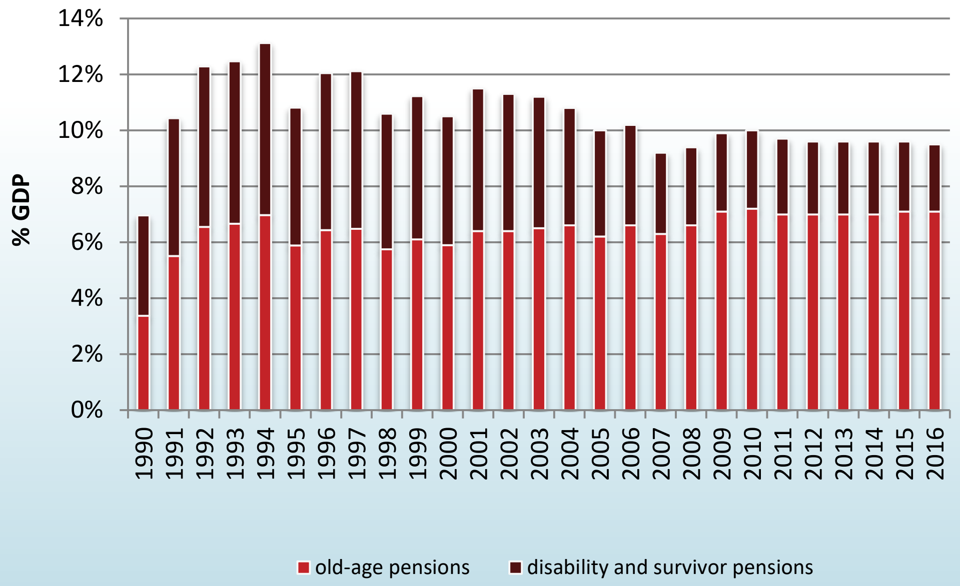
- Reduced social trust towards pension system, undermining the generational contract and social sustainability
  - Government can take away pension saving
  - Multiple pension accounts: NDC, quasiNDC, FDC, 2 types of individual retirement accounts with different tax treatment, Employee Pension Plans (still underdeveloped)
- Population ageing puts significant pressure on labour market development which will affect pension system

Long-term trends

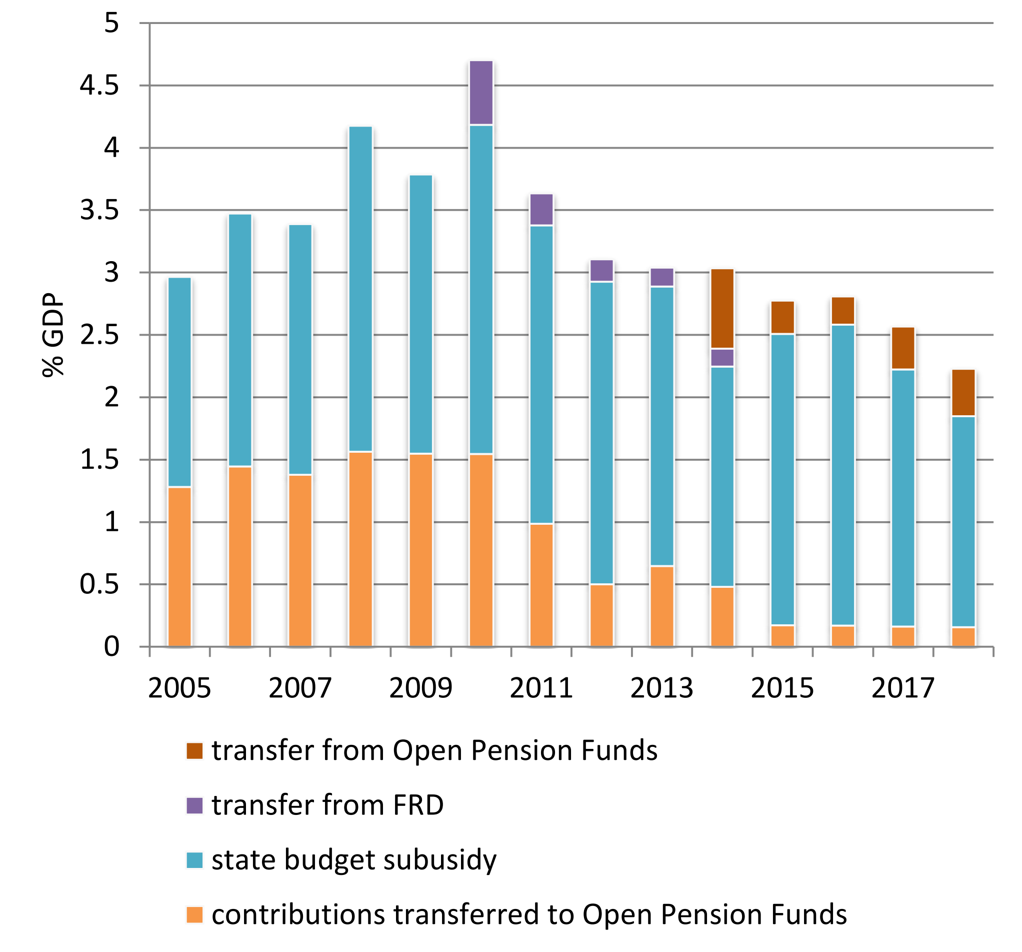
INSURED AND PENSIONERS

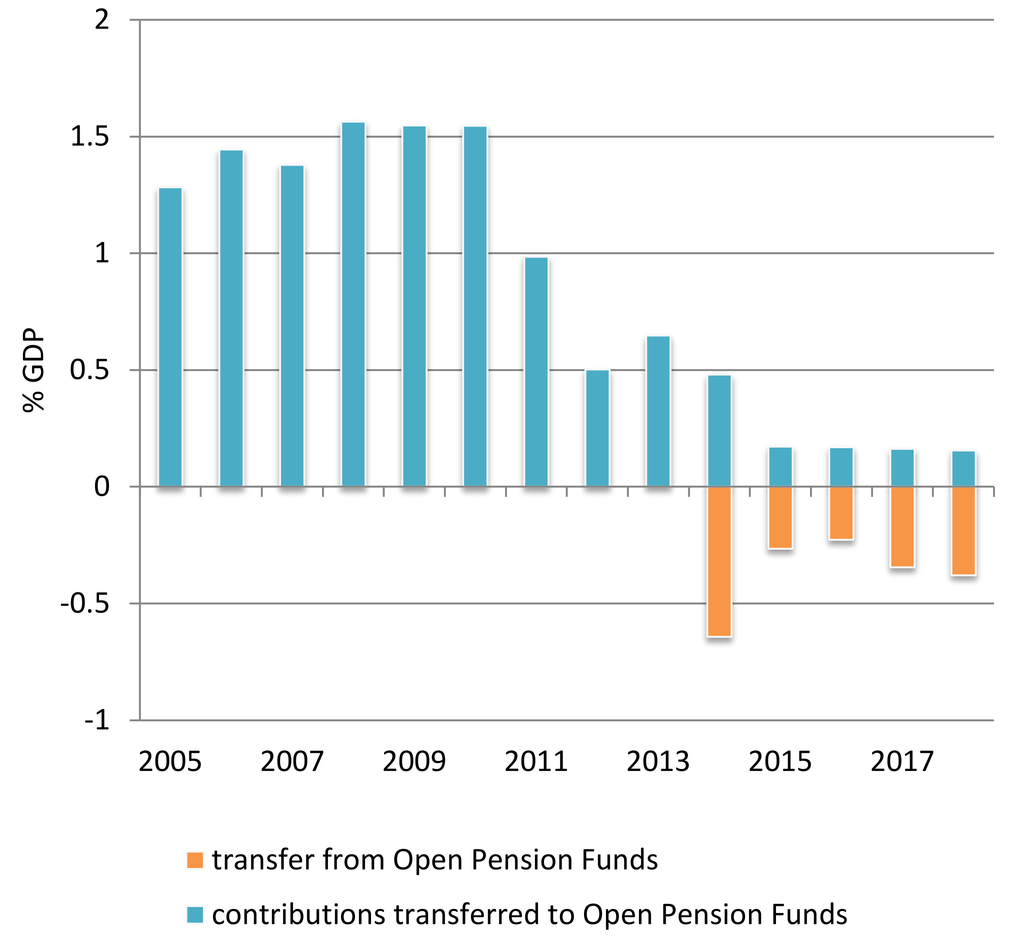


Pension expendiutre



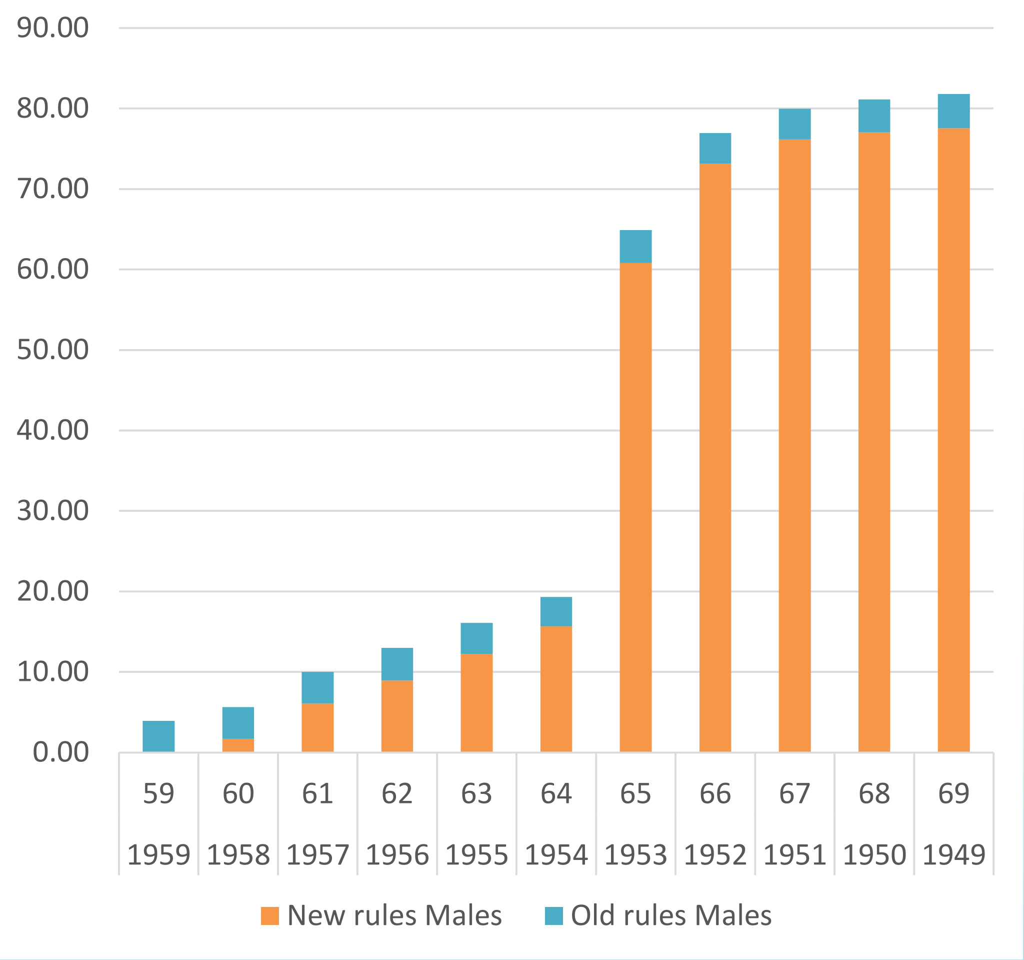
Transfer to the FF and deficit in Social Insurance Fund

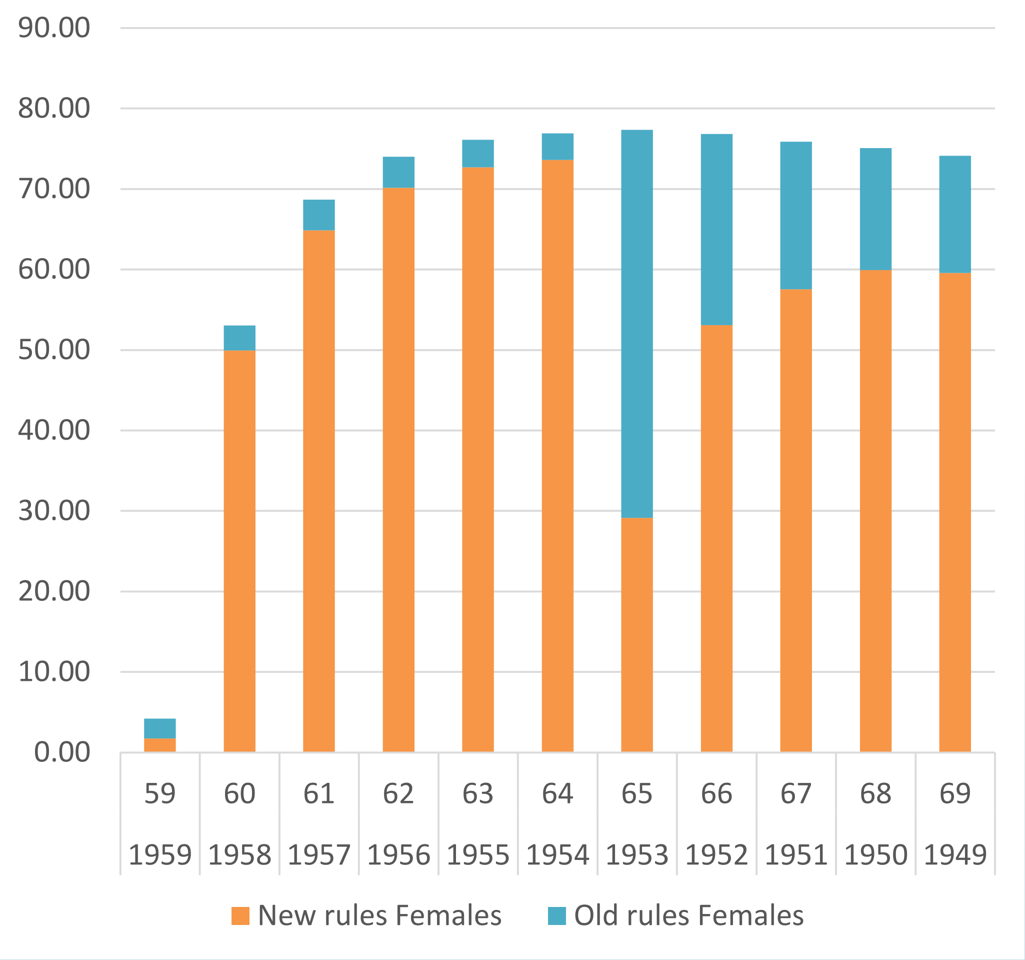




Source: own analysis of social insurance data

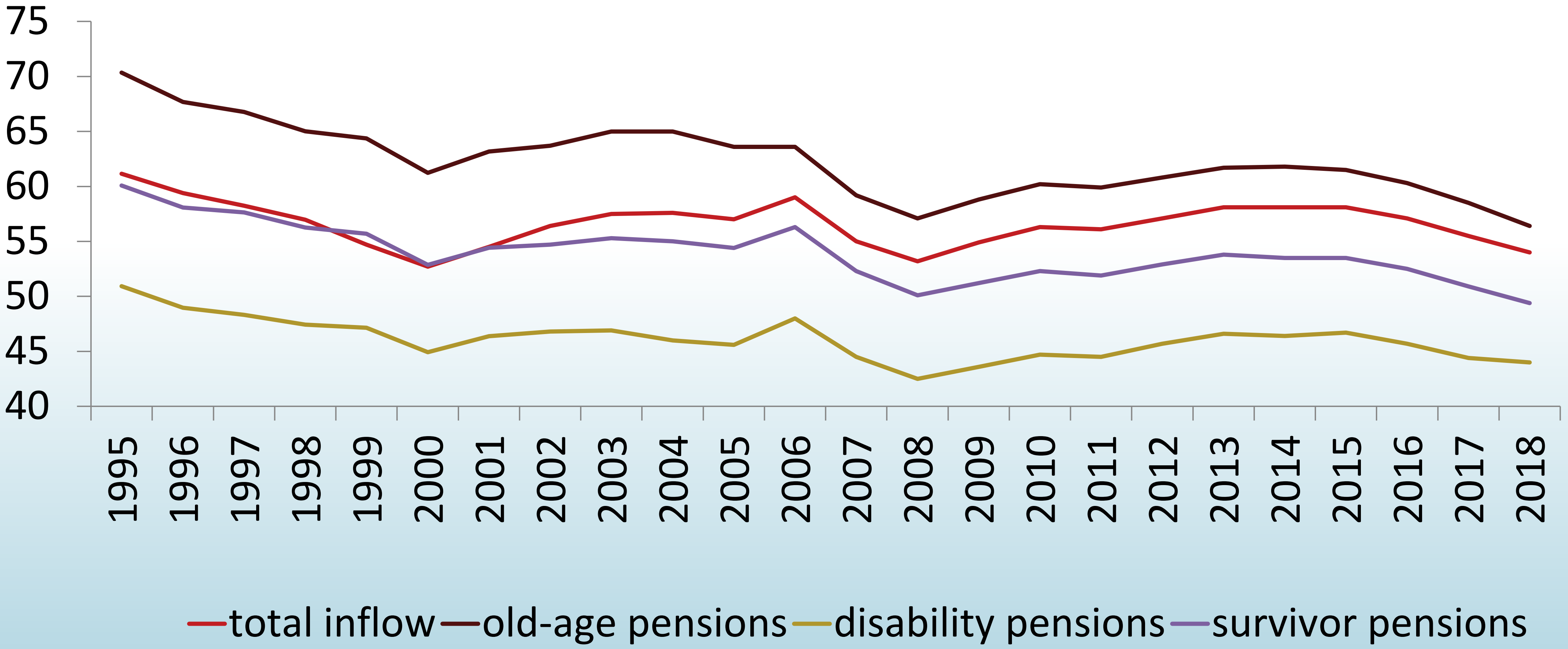
Take up of new pensions by age and sex





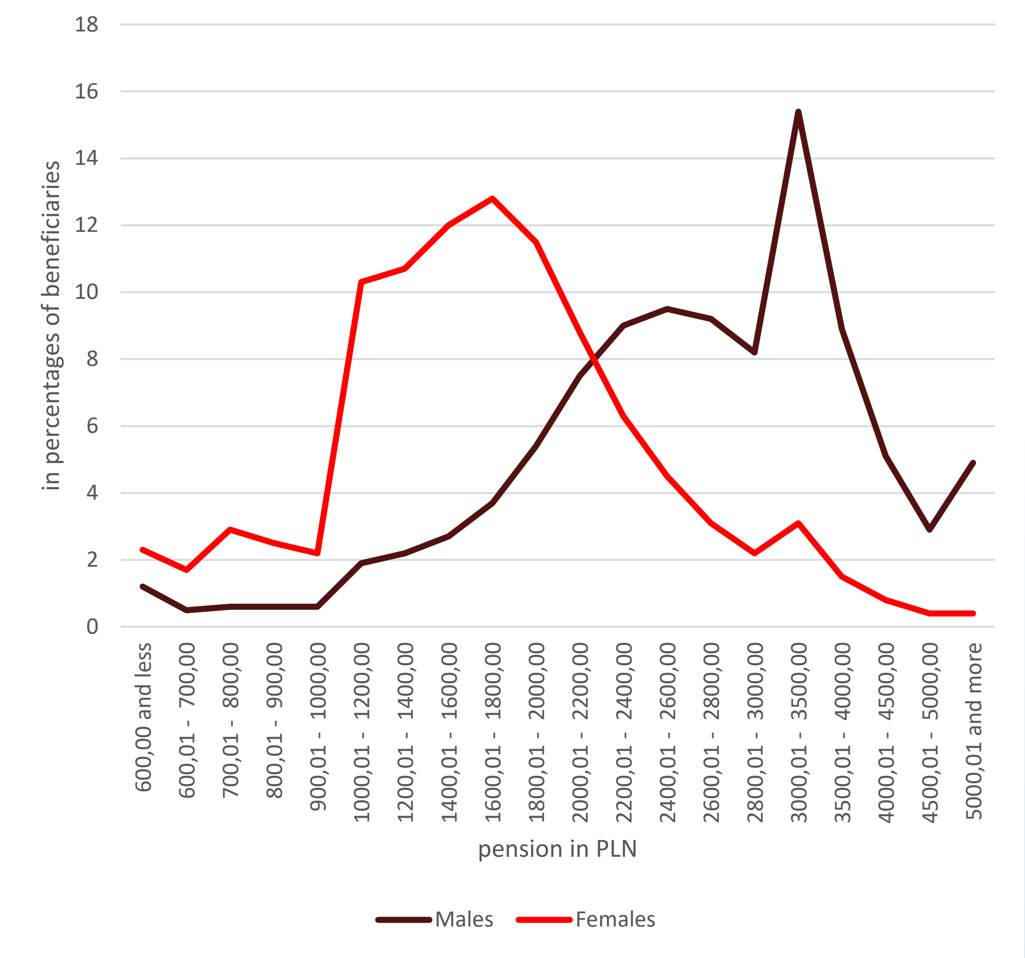
Source: own analysis of social insurance data

Average pension level (% of average wage)



Distribution of new pensions by level

- Women have significantly lower pensions compared to men
- Main reasons:
  - Shorter working careers
  - Lower wages
  - Lower retirement age



Source: own analysis of social insurance data

Performance of the FDC

Rates of return

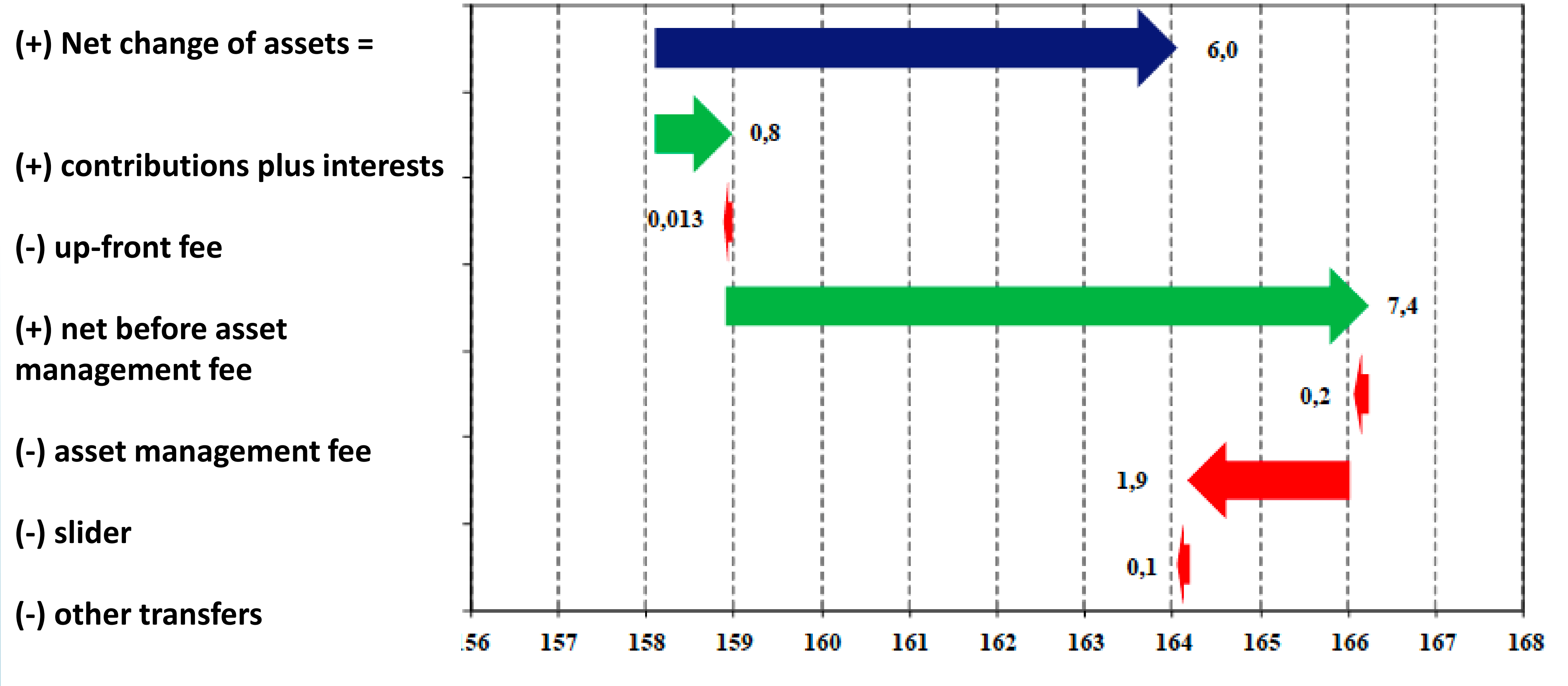
Fundusz	III Q 2017	IV Q 2017	I Q 2018	II Q 2018	III Q 2018
AEGON	3,06	1,13	-7,22	-3,44	4,91
Allianz Polska	3,20	0,48	-6,31	-4,10	5,91
Aviva BZ WBK	4,08	0,51	-6,74	-4,35	4,60
AXA	4,41	0,20	-6,75	-4,31	3,99
Generali	3,94	0,20	-6,92	-2,73	4,30
MetLife	3,89	0,37	-6,77	-3,84	4,50
Nationale-Nederlanden	3,32	0,50	-6,89	-3,83	4,72
Nordea*	3,37	-	-	-	-
Pekao	3,61	0,47	-8,04	-4,66	5,16
PKO BP Bankowy	3,63	-0,24	-6,67	-3,95	3,74
Pocztylion	2,85	0,22	-7,00	-3,86	4,55
PZU „Złota Jesień”	5,24	1,03	-7,29	-3,55	3,99
Średnia OFE	**3,72**	**0,44**	**-6,96**	**-3,87**	**4,58**
WIG	**5,36**	**-0,85**	**-8,42**	**-4,15**	**5,40**
WIG20	**6,68**	**0,32**	**-10,19**	**-3,39**	**7,01**

Assets (in milion PLN)

Fundusz	29.09.2017	31.12.2017	30.03.2018	30.06.2018	30.09.2018
AEGON	7 185,2	15 479,7	14 244,5	13 649,6	14 219,6
Allianz Polska	8 142,3	8 090,7	7 529,3	7 180,8	7 563,3
Aviva BZ WBK	39 851,1	39 469,6	36 453,6	34 556,5	35 834,1
AXA	11 645,9	11 555,7	10 693,7	10 161,3	10 498,3
Generali	8 892,0	8 803,9	8 137,1	7 865,4	8 157,0
MetLife	14 468,9	14 257,4	13 137,6	12 498,7	12 929,4
Nationale-Nederlanden	44 788,6	44 576,8	41 311,9	39 588,0	41 297,7
Nordea*	8 395,4	-	-	-	-
Pekao	2 676,5	2 655,3	2 422,8	2 294,0	2 396,4
PKO BP Bankowy	8 194,9	8 075,0	7 471,9	7 121,7	7 334,6
Pocztylion	3 285,8	3 234,2	2 972,0	2 826,5	2 925,5
PZU „Złota Jesień”	23 538,9	23 333,8	21 349,4	20 337,8	20 908,2
Razem	**181 065,5**	**179 532,2**	**165 723,9**	**158 080,4**	**164 064,0**

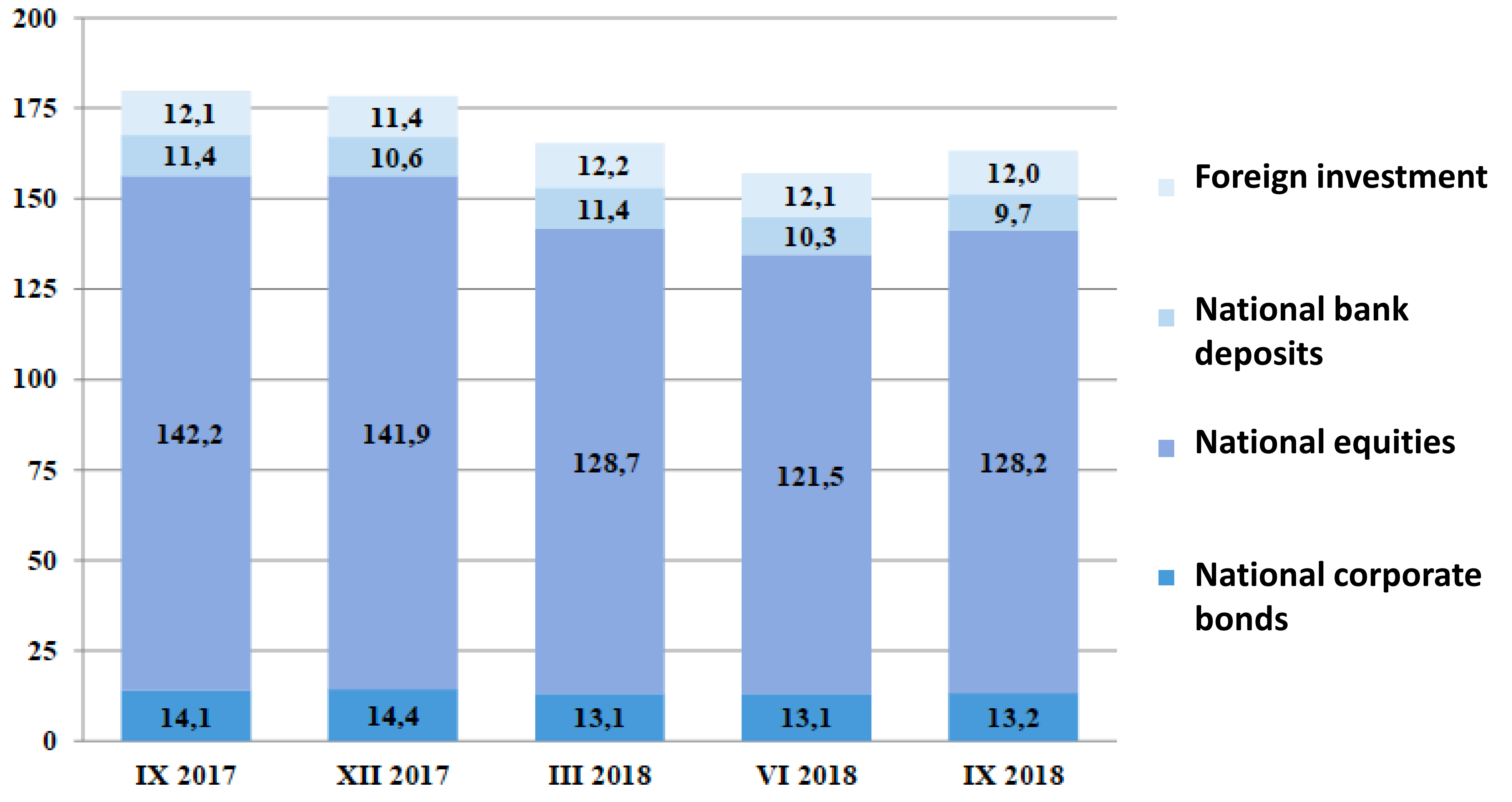
Source: Financial Supervision Commission

Decomposition of asset changes (3rd quarter 2018)



Source: Financial Supervision Commission

Portfolio structure



Source: Financial Supervision Commission

In a nut-shell

Pre-reform	High pension expenditure, low retirement age, low employment particularly among people 50+ (partially due to economic transition offset)
1999	new pension system introduced changing the PAYG DB to NDC+FDC scheme for people born in 1949 or later with OA contribution 19.52% of wages (12.22% + 7.3%)
2008	End of the transition period, reduction of early retriement possibilities (initially planned in 2006)
2011	reduction of FDC contribution to 2.3%, establishment of NDC2 accounts
2013	raising and equalising retirement ages from 60/65 to 67
2014	FDC contribution changed to 2.92% More than half of assets (government bonds) transferred to PAYG and redeemed FDC part made opt-out and opt-in Assets from FF transferred gradually to PAYG 10 years prior to retirement (‘slider’ mechanism)
2017	Reversal of the retirement age increase
2019	Introduction of Employee Capital Accounts - PPKs (autoenrollment additional pension savings 13^{th} pension (1100 PLN) paid to all pensioners in May (just before European Parliament elections) Proposal to transform FDC funds to voluntary individual pension accounts

Consequences of the changes

- Gradually declining pension savings
- Collapse of the financial market in Poland
  - Warsaw Stock Exchange shrinking
- Potentially lower pensions in the future (with already risk of low adequacy of pension benefits)

State of the pension system in 2019

- **NDC holds, its construction allows to maintain long-term balance**
- **The FDC**:
  - Gradually declining assets due to the slider mechanisms
  - Lack of belief that the funds will hold
- **Further changes:**
  - Reversing the raising retirement age to 67 for men and women: back to 60/65, high risk of minimum pensions for women
  - Pension indexation: partially lump-sum
  - Minimum pension raised to 1000 PLN per month in 2017 and 1100 PLN in 2019, strenghtening the poverty protection role
  - New 13th pension with the promise to continue in the future

Boosting savings: Proposal of Employee Capital Accounts from 2019

- Automatic enrollment
- Mandatory for all employers
- Additional contribution with the state copayment

- Initial payment from the state budget :PLN 250 plus annual co-payment PLN 240
- Contributions from employers: 1.5% (basic) + 2.5% (additional)
- Contribution from employees: 2.0% (basic) + 2.0% (additional)

- Asset managers: investment funds

- Payouts: lump-sum or 10-year scheduled withdrawal

LATEST DEVELOPMENTS:

EMPLOYEE SAVINGS PLANS & END OF THE MANDATORY FUNDED PILLAR

Introduction of PPKs

- In November 2018, the new Act on Employee Capital Plans (PPKs) was signed by the President and adopted for implementation from June 2019, establishing a new occupational pension savings scheme (*Pracownicze Programy Kapitałowe*)
- The scheme will cover all salaried workers in Poland (around 11.5 million people) and potentially increase their pension savings
- PPKs will be based on auto-enrolment.
  - The scheme will cover all employees hired in accordance with the Labour Code contract who are between 19 and 55 years old
  - Workers aged between 55 and 70 can join an PPKs voluntarily

Gradual introduction:

July 2019
- Workers in big companies (250+ employees)

January 2020
- Workers in medium-sized companies (50-249 employees)

July 2020
- Workers in small companies (20-49 employees)

January 2021
- all other workers (including public companies)

Contributions to PPKs

Amount of ECP contributions	Mandatory contribution	Voluntary contribution
Financed by employer	1.5% of the wage	up to 2.5% of the wage
Financed by employee	2.0% of the wage (with exceptions)	up to 2.0% of the wage

- Employees with salaries below 120% of the minimum wage will pay reduced mandatory contributions, but no less than 0.5% of their wage
- An additional co-payment will be made from the public Labour Fund. This will include an introductory lump-sum payment of PLN 250 (€60) and an annual payment of PLN 240 (€57) for those who contribute more than the minimum amount

Main principles of the PPKs

- Employers will choose an asset manager from among the following:
  - investment fund companies
  - insurance companies
  - pension fund societies, managing the open pension funds
  - employee pension funds
- The structure of the investment portfolio will be adjusted to the participant's stage in life, with the investment horizon set at a fixed date (2030, 2035, 2040, etc.):
  - In the 2030 Fund, the share of equities must not be higher than 15% of the total assets
  - In the 2070 Fund, it must be no more than 80% of the total assets
- Payments out of PPKs can be made after the participant reaches the age of 60.
  - The standard pay-out option is a lump-sum withdrawal of 25% of the accumulated funds (untaxed), and the rest can be taken in the form of 10-year scheduled withdrawals
  - The entire amount can be paid out in a lump sum, but in such a case 75% of the ECP savings will be taxed. The savings can also be used to purchase an annuity

Pros and cons

Pros

- generation of additional old-age savings and increased old-age income in the future
- private ownership of assets accumulated in the PPKs
- additional stimulus for the development of the capital market in Poland

Cons

- higher tax wedge due on contributions paid to PPKs, as additional contribution will reduce net wages and increase total cost of employers
- increased fiscal costs due to co-payments from the Labour Fund

Assessment (GRAPE think-tank)

- The net increase in savings as a result of introducing PPKs will be smaller than gross savings estimated by the government

- Other individual savings may be reduced by as much as 70% of the amount paid into to the PPK account.

- The PPKs savings will be smaller than the initial level of savings in mandatory open pension funds

2019 announcement: shifting FDC assets to individual retirement accounts

- Draft proposed for the consultation

- Main assumptions:
  - Conversion of open pension funds (FDC) to individual retirement accounts (IKE)
  - Around 15.7 milion people will have a choice
    - to convert their FDC accounts to IKE accounts with 15% conversion fee (default) with an option to further contribute voluntarily
    - Transfer assets to NDC accounts and Demographic Reserve Fund

  Declarations sould be made by January 10th, 2020

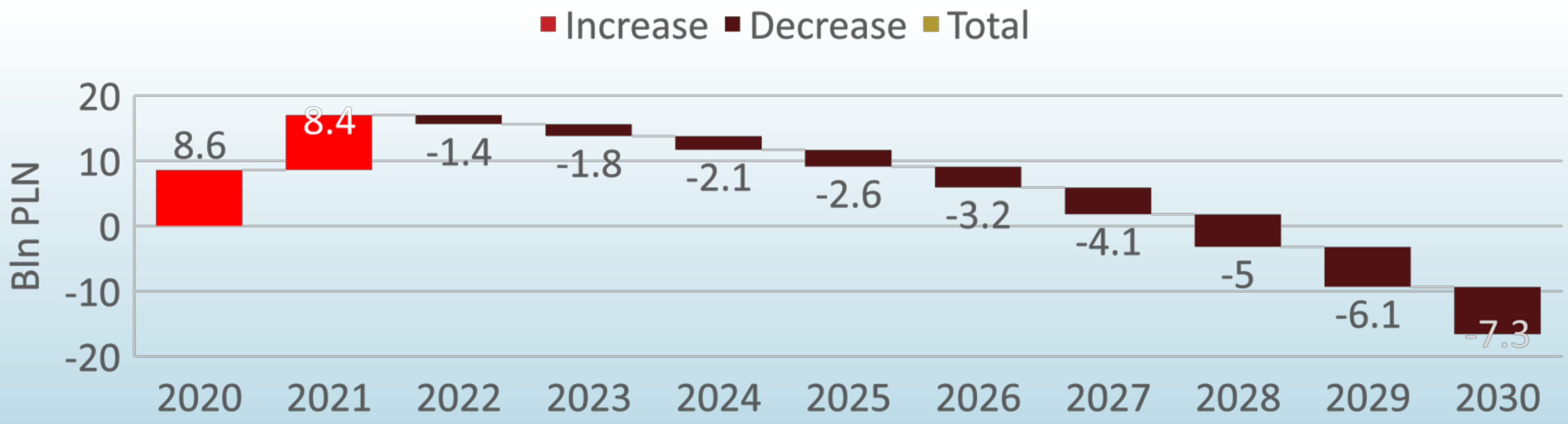
  Transfers will be made as of end of January 2020

- Minimum limit of investment in equities will be gradually reduced from 90% to 67.5% by the end of 2029

- Slider mechanism will be removed

Long-term consequences

- Initially higher deficit of Social Insurance Fund, but smaller in longer run (due to lower pension payments)
- Short-term increase of inflows to the state budget (conversion fee), but decline later (removal of the slider mechanism)



Source: Impact Assessment

Conclusions

- NDC part of the pension system holds, but FDC is dismantled
- Loss of trust towards pension system
- Recent proposals driven by short-term needs
- PPKs have some potential to increase pension savings, but at increased labour costs

Lessons learnt

- Diversification: reducing *risks* by investing in a variety of uncorrelated assets (*micro-level*)
  - but pension system exposed to *macro-level shocks*
- Private pillars not immune to regulatory risks/shocks
  - inflation tax, tax on interest, other regulatory tools, default on bonds, a possibility of nationalization
- The future of pension financing remains a challenge:
  - „demographically old but not yet economically rich”

Lessons learnt

- Reforming pensions requires:
  - Concept
  - Legislation
  - Administration
- Pension reform is a long-term process
  - Launch of the change is just the beginning
  - Ensuring long-term support requires constant activity
  - Things can divert significantly from the initial plan
- Pension system is an important item in the political agenda
- Retirement age is a noticeable point in these discussions
- Short-term gains can be more valued than long-term stability or adequacy (lower retirement age of women)
- Coverage: undiscovered risk

FARMERS’ PENSION SYSTEM

Farmer’s pensions in Poland

- Separate scheme for individual farmers from end of 1970s
- Separate administration of the system – KRUS from early 1990s.

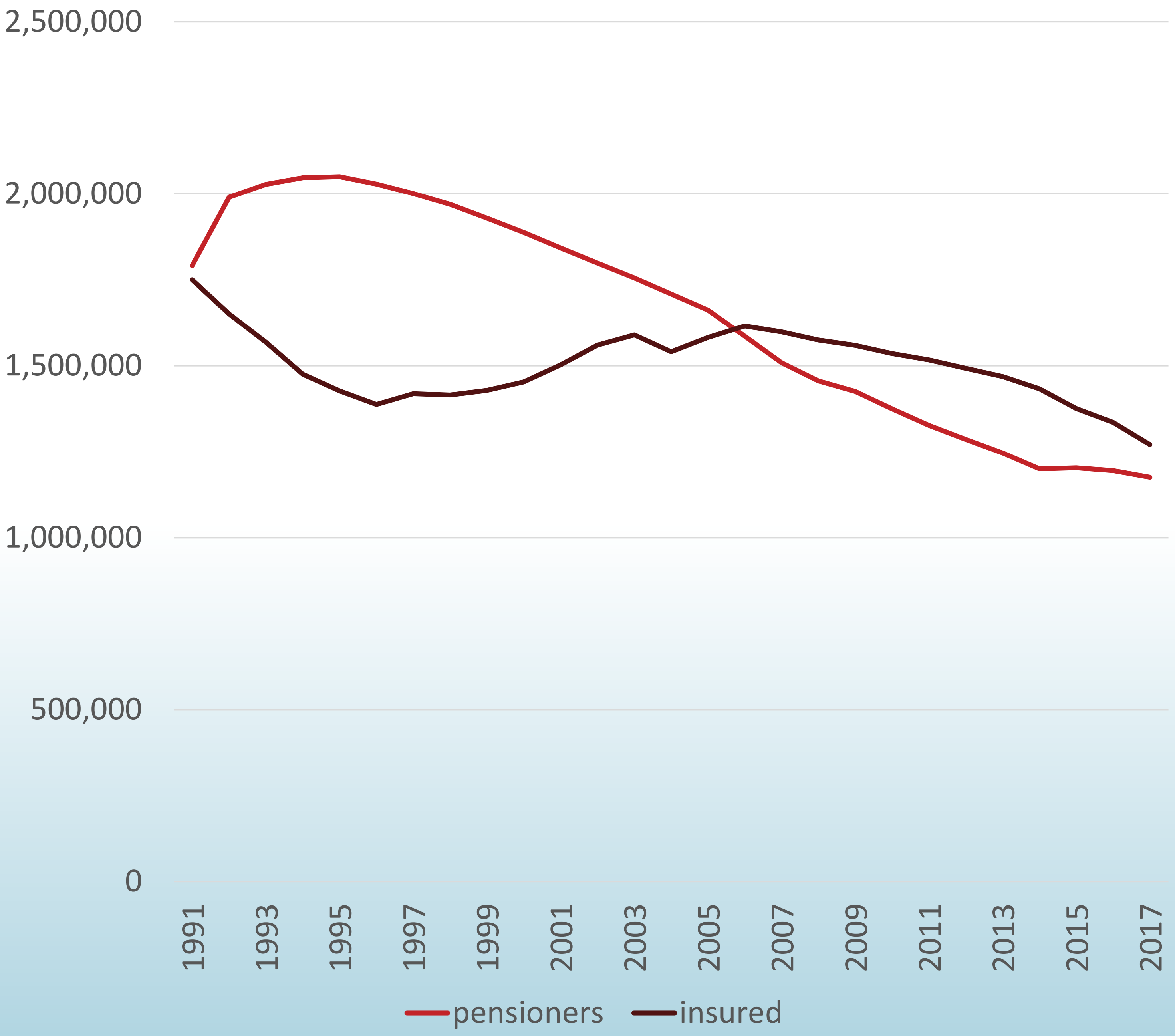
- From the beginning
  - Heavy role of subsidies from the state budget
  - Initially 70 per cent of expenditure, but then increasing to more than 90% of expenditure, due to inflation reason
  - Flat-rate contributions and benefits
    - Contributions more than 8 times lower than for self-employed outside agriculture
    - Benefits at the level around 120%-140% of minimum pension

KRUS – insured and pensioners

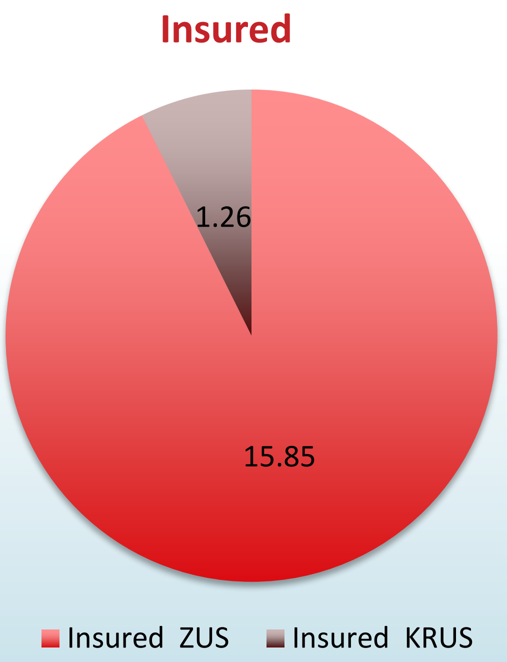
Number of pensioners was larger than insured until mid-2000s

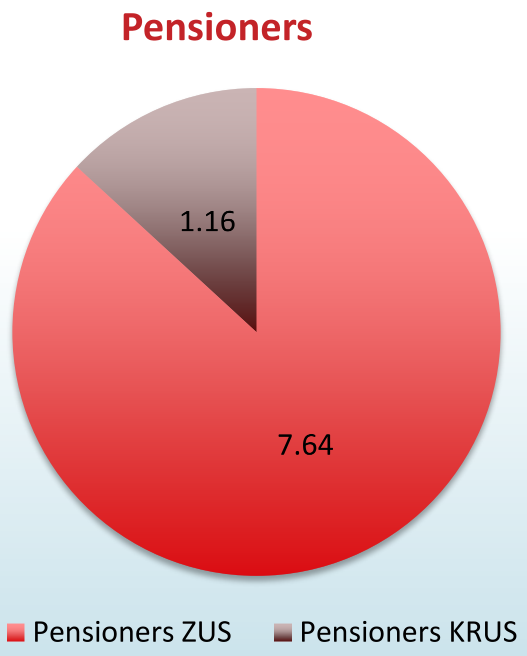
Share of farmers in the employment declines leading to lower number of insured and also pensioners

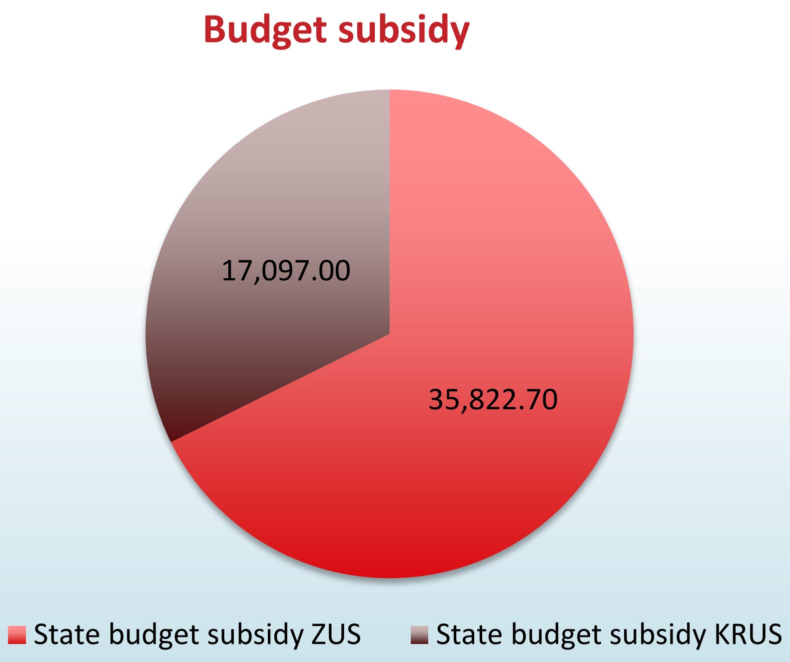
Increase in the nubmer of insured due to legal changes: acces to KRUS insurance for smaller farmers



ZUS and KRUS in Poland, 2015







Simplification of administrative procedures

- Farmers pension system (KRUS):
  - Flat-rate contributions and flat-rate benefits
  - Heavily subsidised by the state budget

- In Poland self-employed outside agriculture (in ZUS):
  - Do not have to file monthly reports (based on annual information, Social Security Institution automatically generates necessary reports)
  - They can provide documents in paper form (for employers who employ more than 5 people electronic format is required)

Pros and cons of separate farmer’s scheme

PROS

- Ensuring coverage for rural population
- Providing significant part of cash income for low-income farmers
- Administration adjusted for the needs of clients
  - Simplified reporting
  - Support in paper work

CONS

- Farmers do not pay taxes
- Subsidising low-income and high-income farmers in the same way
  - Polarised structure – overrepresentation of framers in 1st and 10th deciles
  - Tax-payers from outside agriculture subsidise high-income farmers
- No changes after EU accession, despite significant increase of farmers income due to CAP
- Reduces mobility on the labour market
- Attractive for evasion from general ZUS scheme

Potential reform directions

- Accomodating self-employed and farmers in general pension systems , but:
  - simplified administrative procedures
  - rules for setting contribution rates and contribution bases adjusted to the situation of the self-employed and general economic development
  - keeping adequacy of pension benefits
  - defined-contribution environment better accomodates different employment patterns

DISABILITY PENSIONS

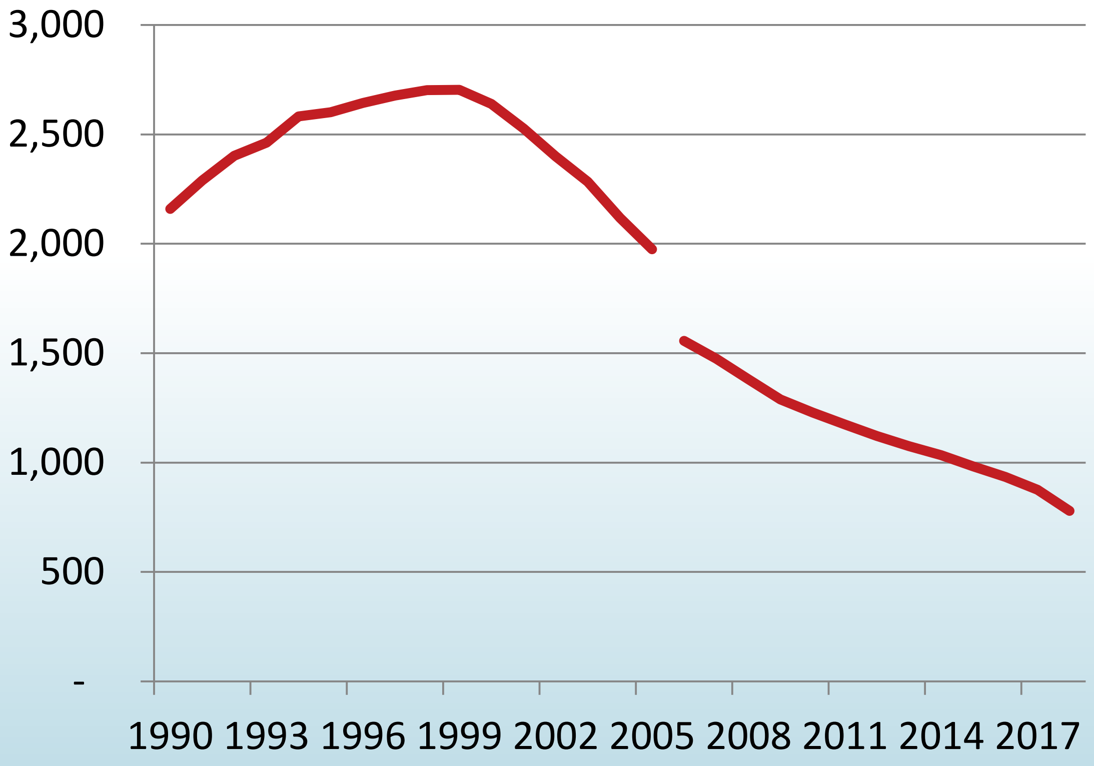
1999 changes in disability legislation

- New definition of disability:
  - Focused on ability to work (full of partial inability to work)
  - Moving away from the notion of health detriment

- Change in the disability assessment
  - Developing network of assessment doctors employed in the Social Insurance Institution
  - Moving away from assessment by doctors’ committees

Disability pensions – reverse of trend after 1998 change of legislation

Number of disability pensions paid



Number of new disability pensions granted