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The impact of changes in second pension pillars on public finances in Central and Eastern Europe: The case of Poland



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ABSTRACT

This paper studies the impact of the recent weakening of Poland's fully funded defined contribution second pension pillar on (i) the long-term sustainability (the deficit and implicit debt) of the full pension system and (ii) the implications for pension benefits (gross replacement rates). Simulation results, based on a stylised version of the Polish pension system, show that, in the baseline scenario, the weakening of the second pillar would permanently lower future pension system debt, chiefly as a result of a cut in replacement rates. But using a combination of pessimistic assumptions including strong population ageing, low real wage growth and an indexation of existing pension benefits on nominal wage growth rather than inflation coupled with bringing in tax expenditures related to the third voluntary pension pillar and an increase in the share of minimum pensioners leads to higher pension system deficits and eventually more public debt at a very long horizon. The simulation results also suggest that if Poland had not transformed its pay-as-you-go first pension pillar into a defined contribution from a defined benefit system, the weakening of the second pillar would deteriorate fiscal sustainability relatively quickly in the baseline scenario. This result suggests that the Hungarian pension reversal would reduce deficit and debt only temporarily, mainly because of Hungary's costly defined benefit first pension pillar: the weakening of the second pillar is tantamount to swapping low current replacement rates (in the defined contribution second pillar) against high future replacement rates in the defined benefit first pension pillar.

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1. Introduction

High budget deficits caused by the financial and economic crisis of 2007–09 and the consequent desire to circumvent existing fiscal rules, mainly European but also domestic, pushed a number of Central and Eastern European countries to weaken (or fully scrap) their second fully funded defined contribution pension pillars. While temporarily or permanently diverting pension contributions from the second pension pillar, which is outside the general government sector, to the first pension pillar, which is part of it, has reduced budget deficits in the short run, the question economists and policymakers may want to ask is whether such moves will be detrimental to a country's long-run fiscal position.

It is precisely this question this paper seeks to address on the basis of a simulation exercise using a stylised model of the Polish pension system. The main questions raised in the paper are the following. What is the impact of the cut in pension contributions going to the second pillar from 7.3% of gross wages to 2.3%, raised back to 3.5% in 2017, on the fiscal sustainability of the Polish pension system? How would the results change if the pension contribution rate would be kept at 2.3%? What would happen if the second pension pillar were dismantled altogether? How would those changes influence replacement rates defined as pension benefits over average earnings at the time of retirement? Does the nature of the first pillar matter (defined benefit vs. defined contribution)?

The simulation results show that weakening the second pillar would permanently reduce future pension system debt in the Polish case, resulting from lower replacement rates. An important reason for this is that annuities paid from the second pillar are calculated as pension assets divided by life expectancy at the time of retirement, adjusted for the risk-free interest rate. By contrast, the calculation of annuities in the first pillar ignores the interest rate, which in turn decreases already low replacement rates. Thus, the weakening of the second pillar implies lower pensions for future pensioners but also lower public spending for the government (in net present value terms). Nevertheless, using a set of pessimistic assumptions for population ageing, real wage growth and the indexation of existing pension benefits (full nominal wage indexation rather than the current mix of 20% nominal wages and 80% inflation), combined with the costs of the planned tax break to savings going to the voluntary third pension pillar and an increase in the share of minimum pensioners, pushes the pension system's deficit and eventually its debt above the levels observed in our no policy change scenario in the very long run. Hence, improvements in long-term sustainability cannot be taken for granted under the pessimistic scenario.

Two additional things are worth mentioning here. First, in an actuarially neutral system such as the Polish first pension pillar, lower replacement rates, arising from the weakening of the second pillar, could be offset by working longer. This would considerably dampen the negative effect of the recent change in the second pillar on replacement rates. Second, reducing the general government deficit by the same amount by weakening the second pension pillar (via increasing revenues) and by cutting spending (or increasing taxes) is not necessarily equivalent. The reason for this is that higher revenues generated by the weakening of the second pillar will have to partly finance an increase in future pension liabilities in the first pillar, whereas a reduction in spending or an increase in taxes do not have a counterpart in the future. Overall, this would mean that while the weakening of the second pillar will permanently improve public debt sustainability in our central scenario, it will do so less than other more conventional consolidation measures would.

Our simulations also help answer the question what would happen had Poland not reformed its first pension pillar (from a defined benefit to a defined contribution system). This counterfactual analysis, which reflects Hungary's position (no reform in the second pension pillar coupled with a fully funded second pillar), suggests that weakening the second pillar in such a case would result in a deterioration of the pension system's fiscal position: deficit and debt are reduced in the short run as a result of upfront savings, but the deficit and debt soon start climbing above the levels in the no policy change scenario. This is mainly because of the high replacement in the first pillar, which implies that the change is tantamount to swapping low current replacement rates (in the defined contribution second pillar) against high future replacement rates in the defined benefit first pillar.

The remainder of the paper is organised as follows. The next section briefly discusses pension reforms launched in 1998/99. Section 3 describes the recent wave of actions aimed to weaken the

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