
Pension Reform in Poland

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The decade of the 1990s has been a fascinating one, both politically and economically, in Eastern-Central Europe and beyond. The process of transformation away from Communism began with the election in Poland in June 1989, in which Communists were soundly defeated. Soon we witnessed the disintegration of East Germany, the *Velvet Revolution* in Czechoslovakia, and the rebellion in Romania, eventually bringing the collapse of the Soviet Union. While the events in the formerly Communist countries of the early 1990s were quite unique to those countries, in time they all faced a problem common to many countries worldwide, the pension crisis (WB, 1994). The way this problem presented itself in Eastern-Central Europe—especially Poland—was, however, substantially different than in the most developed industrialized nations, and, in our opinion, can shed a new light on the same issues in the rest of the world. The World Bank presentation suggests viewing the pension problem as purely a demographic phenomenon. This is not the case in Poland: its “old-age crisis”—that is, a significant imbalance between the size of the elderly generations, and the generation of current working age, is about 20 years in the future. But these authors find the demographic explanation greatly lacking in economic insight. The former Communist economies faced the pension crisis very quickly, without the demographic underpinning suggested by the World Bank. What they had instead was nearly universal state pricing of pension

annuities—that is, a practical state monopoly of retirement provision. The old-age crisis is indeed a crisis of state pricing of retirement annuities, and as the case always is with state pricing, it has produced a shortage. This time it is a worldwide shortage of retirement annuities.

Poland was the leader in both the political reform, and the economic reform, in Eastern-Central Europe. It has had an organized political opposition movement to Communism since circa 1976. That movement culminated in the explosion of the *Solidarity* trade union in 1980, followed by its crushing by the *Martial Law* imposed on December 13, 1981. But the brutality of the suppression of the free union movement did not stop the gradual “Polish way out of Communism.” Even with hundreds of thousands of political prisoners, and with state special security forces ZOMO killing some of the protesters, peaceful opposition continued throughout the 1980s. By the mid 1980s, the Communist government, struggling with declining standard of living and increasing difficulty of making foreign currency debt payments, began toying with economic reforms. One of the Communist Ministers of the Economy even promised that during his term, within a year, fresh bread and rolls would be available throughout Poland. He did have the good sense to resign a year later when the promise was not fulfilled. By the end of the 1980s, the Communists decided to start negotiations with the *Solidarity* leaders about at least limited power sharing agreement. These so-called Round Table Negotiations, in which the Communist party bosses met with people they previously considered jailbirds, culminated in an agreement calling for a limited free election in June 1989. In that curious election, a portion of the parliament was assigned to the Communists, while the remainder was elected freely. The Communists fielded candidates in both parts, but lost dramatically and were only elected in the part assigned to them by the agreement. *Solidarity* then offered to the Communists a deal whereas the government would be formed by *Solidarity*, but the presidency of the country would remain with the Communists, and be assigned to General Jaruzelski, the perpetrator of the 1981 *Martial Law* terror and massive arrests. Free presidential election was subsequently held in 1990 and won by Lech Walesa, *Solidarity* leader (in an amazing twist of fate, the subsequent 1995 election was won by a former Communist youth leader, Aleksander Kwasniewski, who became a force for reform within the Communist party and made it into a power in Polish politics, the social democrats).

The new government, created by the 1989 election, started a rapid reform program—that is, the *Balcerowicz Plan* (named after the Minister of Finance of the said government). Its main points were: freeing the consumer goods prices, privatization of some state-owned enterprises, easing of tariffs, and allowing interest rates to float freely, as well as allowing (a big change after Communism) unemployment. The plan, however, did not extend any of its market approach to the pension system. In fact, the new government has expanded early retirement and disability provisions, previously granted by the Communist government in a limited

fashion. We should add that the pre-1990 Communist governments have attempted to reform pensions, but those reforms were mainly in the form of raising the payroll tax. One substantial change was the separation of the retirement social insurance budget from the general revenue budget, achieved in 1986 with the creation of the *Retirement Fund* administered by ZUS (Social Insurance Enterprise).

A comprehensive review of the pension system history in Poland, and its issues for reform, is given in a recent Polish book by Stanisława Golinowska (2000), a leading scholar in this area in Poland. Notably, in 1989, pensions constituted only 8 percent of GDP, and the payroll tax was set at 38 percent. By 1992, pension expense reached 15 percent of GDP, and the payroll tax rose to 45 percent. Pensions were indexed to wages, and the rapid pace of reform, with great structural changes in the economy and resulting unemployment, combined with high replacement rate of wages by pensions, over 70 percent, created strong early retirement incentives, only made easier by the *Balcerowicz team*, which believed that this was a way out of the unemployment problem (falsely, in our opinion, as retiring workers do not necessarily leave jobs to the younger workers—since in retirement they often reduce their consumption, resulting contraction in aggregate demand may eliminate the jobs they had just left behind, making everyone worse off).

By the mid-1990s, Poland and many other Eastern-Central European countries were facing serious problems in the financing of their pension systems. The problem was indeed especially pronounced in Poland. In the years 1994 to 1998, pension expenditures averaged roughly 14.5 percent of GDP. These substantial, and only paid by the public sector (in view of the virtual state pension monopoly created by Communism) expenses were financed by issuing public debt, the cost of which is estimated by Gomulka and Styczen (1999) to be at least 2.5 percent of GDP. By 1995, pension funding became one of the most important issues in the Polish economy. While the overall economy began a rather powerful recovery in 1992, the pension system was in a continuous deterioration. The problem was exaggerated by the political changes of 1993, when the former Communists (renamed social-democrats) came back to power in the election, and generally followed a “hands-off” policy towards any changes in approaches to the economy. However, beginning in 1995, even the “hands-off” social democrats were forced to begin a process of preparation for a comprehensive pension reform. Following the 1997 election, *Solidarity* coalition came back to power, with the program of four major reforms: administrative, pension, health care, and education. This accelerated the process, and in 1999, new pension system was put in place.

Global and Polish Pension Crisis

The World Bank (1994) document has brought to the forefront of the economic debate the global issue of funding of pensions. As many countries have experienced a birth boom following World War II, and a reduction in the size of adult population

due to war, it appears that the retirement of the post-World War II generation may be difficult to accommodate for many economies worldwide. Over time, birth rates in the developed world have declined, in many cases below the natural replacement rate of roughly 2.1, and looking into the future many countries project a sharp decline in the dependency ratio, i.e., the ratio of the size of the working population to the size of the retired and disabled population. The combination of these factors has produced a global crisis, which is often perceived as a demographic phenomenon. We would like our readers to entertain a different hypothesis, which we believe to be of significance, especially in the case of Poland. Polish social insurance system was created in 1920, following regaining of national independence in 1918. It is administered by Zakład Ubezpieczeń Społecznych (Social Insurance Enterprise), ZUS, the social insurance agency of the state. The system is modeled on the German social insurance scheme going back to the original Bismarck design. Until the new reform changed things, under the old system, ZUS collected payroll taxes for retirement and disability social insurance, as well as for unemployment benefits, and distributed those as prescribed by the law to retirees, disability beneficiaries and the unemployed. Until 1987, retirement benefits were not indexed in any way, and effective 1987, indexation to wages was introduced (changed in 1995 to inflation indexation). The system had all basic characteristics of social insurance: (1) it was meant to be self-financing (pay-as-you-go); (2) benefits were statutory, defined by law, and had no link to individual contributions on behalf of the employee, and (3) the system was administered by the state.

It should be noted that in its older, Communist-era, period, the system had cash-flow surpluses, which were utilized by the state budget without any specific accounting provision for this use of funds (amounting to a grant of funds from social insurance to general revenue budget). As the transformation outlined in the *Balcerowicz Plan* started, unemployment rose, and early retirement as well as easier disability provision was implemented, cash flow surplus quickly became a cash flow deficit, which was financed by general revenue budget.

Box 5.1: Formula for Initial Pension Benefit

$$\pi_i = 0.24 w_s + 0.013 n_i w_i + 0.007 m_i w_i + \pi_i^*$$

Note: w_s = the national average wage; w_i = the average wage over the last several years (from 2 to 10, depending on individual circumstances); n_i = number of contributory years of work; m_i = number of contributory years of non-work (higher education, unpaid leave for mothers, 3 years per child up to 6 years, and period of receiving a state disability pension); and π_i^* = any special pension right (such rights were granted to certain employment groups: miners, soldiers, police, with some privileges also given to teachers, railroad workers, steel workers, sailors and some other groups).

While the subsidy from the general revenue budget to social insurance can be perceived as a burden for the overall economy, one can actually make a case that such subsidy represents merely a return of previous excess social insurance contributions (Ostaszewski and Urbaniak, 1995). Given that there was no accounting for the assets transferred from social insurance to the state, and no market prices for those assets, this hypothesis is, of course, impossible to verify. For most of the 1990s, the formula for initial pension benefit was as shown in Box 5.1 (Gomulka and Styczen, 1999).

What we would like to point out here is the contrast of such a pension scheme versus a private sector alternative. In the absence of a state pension, an individual purchases capital assets and the size of his or her final pension is determined by the contribution rate, rates of return available on capital assets, and the rate of purchase of annuities at the time of retirement. The crucial element of the private retirement system is that the rate of return, or the current purchase price of the future annuity, is determined by the market forces (and, unless one settles for an extremely expensive, fully guaranteed choice, subject to considerable uncertainty). What a state, even pay-as-you-go, system amounts to is state pricing of annuities, or capital assets in general, with a large portion of the risk of those annuities absorbed in the diversification allowed for by the universal nature of the system. Such a state system strives to achieve two goals, generally viewed as crucial for public policy, i.e. universal pension coverage, and alleviation of poverty among the elderly.

What is missing here is the key point that all systems of state pricing, including state pricing of cars, shoes, books, and indeed capital assets, as well, lead to inefficiencies: either shortages or excess supplies of goods and services not priced by the market. The current global debate about the pension crisis seems to largely ignore the fact that the crisis manifests itself in state pension systems, not in private retirement systems. State pension systems have produced a *shortage of annuities*, by reallocating resources away from production of annuities (i.e., economic investment and population expansion) to consumption (admittedly, in order to alleviate poverty, but one has to ponder if poverty is, in the long run, alleviated by consumption or by production?). Private pension systems generally do not lead to such shortages, but they are also unlikely to achieve universal coverage without some form of government mandate. Notably, the Chilean pension reform of 1981 has replaced previous state system by a universal system of privately priced pensions, and so did subsequent similar reforms in other countries. However, universal coverage under those systems is still achieved through state mandate.

State systems of pricing are also prone to non-market political methods of allocation of resources. Various political entities can lobby state agents to have resources allocated to them at preferential prices, or without paying for them at all. This crucial feature of state systems of pricing manifested itself dramatically in Poland during the late part of the 1980s and early 1990s. While under Communism totalitarian powers of the government allowed it to control allocation of resources to

retirees at will, as the powers of the central government were relaxed, and democratic and free-market reforms introduced, lobbying on behalf of the unemployed and underemployed became more effective. To alleviate the social cost of transformation, early retirement was allowed (and often encouraged) and the criteria for granting disability pensions were relaxed. As the government became less repressive and the private sector grew, it also became possible to evade payroll taxes. The combination of higher costs of pensions (more retirees and pensions for the disabled), higher unemployment, and lower taxable payroll (due to unemployment and evasion), had dramatic consequences. By 1995, the tax rate for pensions and disability stood at 45 percent. In addition to that, payroll tax of 3.18 percent was collected to unemployment and related benefits. This payroll tax was paid entirely by the employer, and it was paid as a percentage of the net pay before income tax (roughly equivalent to 31 percent of gross pay). This, of course, caused the labor costs to be very high, discouraging employment, additionally contributing to the problems of the pension system. On top of that, a significant informal economy has developed, where this high payroll tax was not paid at all, causing workers to lose their social protection, and pulling many legal entities, unable to compete with cheaper informal businesses, into the underground black market part of the economy. This informal economy, while providing often valuable goods and services, usually did not pay payroll tax, and other taxes as well.

One missing element in this analysis is the painful inheritance of non-market pricing of consumer goods in the Communist period: hyperinflation. During the extended period of price controls, which ended in 1990, extensive shortages of most goods, and surpluses of some, developed. When market was finally allowed to clear, prices of goods adjusted rapidly, causing the hyperinflation experience of the early 1990s. In fact, price increases had been happening in Poland since early 1970s, and were continuously a part of political problems. Most of anti-Communist protests in 1970, 1976, and 1980, were sparked by government's decisions to raise prices of some essential consumer goods, such as sugar or meat. Given a history of imperfect and inconsistent indexing of pensions, we can see how hyperinflation had contributed to the pension crisis.

The pension and disability system was also a major tool of poverty alleviation policies, and in absence of other pension resources, ZUS was the effective pension monopoly in Poland. On top of that, while many workers retired early, took disability benefits, or became unemployed, the remaining ones participated in a rapidly recovering economy, with real wages showing significant gains. As the benefits were indexed to wages, retirees indirectly benefited from the strength of the new economy, but did not pay for the costs of the same economy expressed in high rate of unemployment, underemployment, and work force withdrawal. State payroll tax receipts did not grow nearly as fast as the wage index. Because of the combination of these factors, and the generosity of early retirement provisions, the replacement ratio (ratio of the pension to the last wage) for the state pensions grew

to 68 percent, shockingly high by the world standards. For comparison, such ratio is roughly 60 percent in Belgium, 50 percent in Germany, and 25 percent in the United States.

This situation dramatically illustrated the key failing of any state pricing: resources end up being dramatically misallocated. This does not just happen for gasoline price controls in the United States, or toilet paper price controls in the Soviet Union. Price controls must produce some shortages and some gluts, for consumer goods, for machinery, and for capital assets. As a result of state pricing of retirement annuities, large segments of population were encouraged to participate in the political game of early retirement and disability, and discouraged from participating in the labor force. Directly and indirectly, these segments of population have lobbied for greater domination of state-priced annuities in the retirement/disability annuities market, and this lobbying was extremely successful. But long-term success of lobbying does depend on the underlying production, and the state's ability to tax it. Even as the production has recovered in Poland, the state's capacity to tax it has diminished. Even the state owned enterprises began delaying their payroll tax payments to ZUS. Not only the informal sector was cheating on their taxes, everyone learned the game.

Our key insight in this discussion of the Polish pension problem is a perspective, which we believe to be suspiciously absent from the global pension crisis debate. Could it be that the global pension crisis is not a demographic phenomenon after all? Indeed, the unusual demographic developments in the world, especially among the industrialized nations that participated in World War II, can be naturally expected to be priced into capital assets. If there are fewer people, human capital must become more expensive, and capital assets must become relatively cheaper. The markets will include all available information in the prices. But one cannot expect them to work so easily in the state pay-as-you-go systems. Markets adjust prices of future consumption (that is, capital assets) in a continuous manner based on the information becoming available. Payroll tax, pension formula, and indexing provisions of state pension systems require an act of the legislature to be changed. It is not always immediately obvious what the long-term consequences of demographic shifts are, but the market process allows many participants to express their opinions about them, again and again, during every day of trading of stocks and bonds. The volatility of private capital markets may not be always pleasant to market participants, but it allows quick and decisive action, where political process could take years. State pricing of capital assets is, of course, especially dangerous in a totalitarian state where not only market bets opposite to the state expert predictions cannot be placed legally, but even free expression of disagreement with those predictions is stifled. We should not be surprised that the global pension crisis looms largest in the former and current Communist states. Ironically, it looms larger in former Communist states than the current ones, because all of Communist economies are in a crisis, so pensions are no exception, while in formerly

Communist economies, pensions usually remain vestiges of the old system, while the rest of the economy reforms its way out of totalitarianism.

Reform Process

In 1994, the Government of the Republic of Poland published a strategic document entitled *Strategy for Poland*, which identified key problems with the existing pension system as:

1. low effective retirement ages,
2. excessively lax disability criteria,
3. high replacement ratios,
4. large redistributive component in the pension formula, and
5. excessive privileges for some categories of workers.

It was also noted that, because of the effective monopoly of ZUS, the pension system lacked diversification, which could be achieved with addition of private voluntary arrangements and private compulsory arrangements. It is quite common (WB, 1994; Gomulka and Styczen, 1999) to speak about an effective pension system as a three-legged stool, such three legs being:

1. the state compulsory system,
2. the private compulsory system, and
3. the private voluntary system.

The Government of Poland has started the path from one-legged stool to this three-legged stool with its 1994 publication. 1995 was the year of "increased pressure" for the pension reform. By then, the general revenue budget subsidy to ZUS became the largest single entry in the entire Government budget. Given Poland's long-term ambition of joining the European Community, it became clear that without a comprehensive pension reform Poland was extremely unlikely to meet the EU criteria concerning the size of the budget deficit. The World Bank (1994) publication, a widely cited study, was extremely timely for the Polish situation.

On June 8, 1995 a free-market think tank based in Warsaw, Adam Smith Research Center, the oldest such entity in Poland, founded in 1989, hosted a widely publicized conference "Pension Reform: A Prerequisite for Economic Growth" in which the architect of the Chilean pension reform, Jose Pinera, was the keynote speaker. Pinera argued for a total privatization based on the Chilean model. On June 22, 1995 Ostaszewski wrote an article in *Rzeczpospolita*, presenting a similar idea in print. The next year, 1996, was pivotal. A conference sponsored by World Bank was held in Warsaw, with keynote presentations by Luca Barbone and Michal Rutkowski. Subsequently, the new Office of the Government Plenipotentiary For

Social Security Reform was created, with its head given the rank of a government minister. Its first leader became Andrzej Baczkowski, a tireless, hard-working proponent of reform, who laid the groundwork for the future developments, and was greatly praised by all sides of the political debate in Poland. After his untimely death, he was replaced by Jerzy Hausner who held this position for a relatively short time in 1997. Following the 1997 election, the responsibility was assumed by Ewa Lewicka, who became a powerful force for reform. In late 1997, a blueprint for reform was prepared, and submitted to the parliament for review. The Office of the Government Plenipotentiary For Social Security Reform also created brochures entitled *Security Through Diversity* (Polish Government, 1997), which provided a simplified, popular and widely distributed presentation of the proposed new system. Despite many calls for a full privatization Chilean-style, the Office of the Government Plenipotentiary For Social Security Reform decided to create a hybrid of the Chilean system with the Swedish system of "virtual accounts." The key proponent of this approach was Marek Gora, one of the main architects of the reform.

The motivations of the proposed reforms were both macroeconomic and microeconomic. One microeconomic concern was to create better link between contributions and benefits, providing better labor incentives (including incentives to leave the informal sector and enter the legal economy). The second issue was to lower the employer payroll tax contribution, in order to lower labor cost, and improve incentives for creation of new employment. Two key macroeconomic concerns were: lowering the aggregate level of public expenditures on pensions, and creating incentives for growth of a private savings pool, and a resulting capital deepening.

Key Points of the Reform

A comprehensive reform package was prepared and presented to the Polish parliament in 1998. The system became effective January 1, 1999. The most important step in the initiation of the new pensions occurred April 1, 1999 the first day Polish workers were allowed to put their savings into new individual accounts. The new pension system consists of three "legs," or tiers, as we will call them now. *Tier 1* is the compulsory state system, *Tier 2* is the compulsory private system, and *Tier 3* is the voluntary private system. What is very important to note is that while in the old system pension benefits were determined by government fiat, in the new system, all three tiers will pay pensions (required to be in a form of a lifetime annuity for the first two tiers) determined by the market forces, or at least by market-related objective macroeconomic data. This introduces badly needed market discipline, and should be very beneficial to the long-term solvency of the overall system.

The Polish reform is not a complete privatization. State pension system, *Tier 1*, remains the dominant part. But the reform did create universal access for all Polish workers to professionally managed individual investment accounts, which will allow them to enjoy the benefits of capital markets. The key provisions of the new system are as follows:

1. Persons born before January 1, 1949 remain in the old state system, and receive benefits as prescribed by appropriate legislation. Those born between January 1, 1949 and January 1, 1969 are allowed to choose between the old and the new systems. Younger workers must join the new system.
2. The old payroll tax for pensions was 45 percent, and the employer paid it. Half of it now becomes a part of wage base (the other half is paid the same as before), but contributions to *Tier 1* and *Tier 2* are tax-deductible for income tax purposes, thus the tax situation of workers and employers remains the same as before. In the new system, 35 percent goes to ZUS, and is divided between a pension contribution, and a disability premium. 9 percent is redirected for workers to contribute to new accounts that they can set up with a private investment fund of their choice. Those accounts closely follow the Chilean model. There is one crucial difference. The 9 percent going to the private accounts does not go there directly, but is first paid to ZUS which then forwards it to an appropriate pension investment company, based on individual worker's records.
3. Payroll tax contribution to *Tier 1* is used to continue a scaled-down state system. That system now also has individual "virtual" accounts (modeled on the Swedish reformed system). Deposits are held in workers' names, and interest is accrued to them based on the rate of growth of taxable payroll (not a market rate, unfortunately, but this peculiar way of crediting interest may create a hedge for the government against giving away benefits not supported by the economy). The state system allows the retirement benefits to be paid out only in the form of a pension at the statutory retirement age (early retirement age is defined as 62, and there is substantial credit for delaying retirement). The amount of the pension is based on the life expectancy of the cohort of the worker (creating an amazing incentive for workers to encourage their contemporaries to lead unhealthy lives, since if people in their generation die younger, they receive a larger state pension—some say that as a result, mathematically inclined yet heartless, teenagers may encourage their peers to smoke, while abstaining from smoking themselves).
4. Companies managing private accounts must receive the approval of a special newly created regulatory agency, the *Office of the Superintendency of Pension Plans*, headed by an early proponent of the reform, also a tough and demanding regulator—Dr. Cezary Mech. Companies must meet minimum capital requirements,

and their activities are subject to regulation and supervision. In particular, if they deliver returns significantly below the overall industry average, they may have to make contributions to their customers' accounts from their own capital. Additionally, there is a state guaranty fund to cover any losses due to any bankruptcy of a pension plan provider/manager (which is unlikely, but always possible). Companies managing pension money also face restrictions on their portfolios, limiting their foreign and derivatives exposures. These restrictions are somewhat heavy-handed, and one could only hope that over time they will be gradually lifted. But it is also quite clear that they are a product of the political process that led to the reform. Such process required compromises and calming fears about revolutionary changes. At this point, 21 private companies have received licenses to be pension plan providers for Polish workers. Most of them are alliances of Western and Polish financial institutions. Among the western financial institutions which entered this new market are: Aetna, American International Group, Allianz, Commercial Union (which runs fantastically successful insurance company in Poland), Amvescap (whose pension company, Arka-Invesco, is a joint venture with the Catholic Church), Citibank, Nationale Nederlanden, Banco Espirito Santo, Bank Paribas, Nationwide, Winterthur, Zurich, Hamburg-Mannheimer Versicherung, Pioneer. Interestingly, the largest Polish cable television company, Polsat, also runs a pension fund.

5. While the workers could start putting their savings into the new system on April 1, 1999, it was at the beginning of 1999 when advertising campaigns for the new pension plans started. One could see ads everywhere: on billboards throughout Poland, on television, and hear them on the radio. Commercials for pension funds have been quite ingenious, referring to the need for financial security, but also to familiar characters from popular movies or books. The most popular commercial shows a little boy named Bogdan, playing soccer with his teddy bear, giving the bear instructions on proper performance of its duties as a goalie. The message is: Bogdan says "Bankowy." Bankowy is the name of the pension fund provided by a consortium of leading Polish banks. While one can hardly find any connection between a teddy bear, a boy playing soccer, and pensions, this was indeed the most popular commercial. Alas, the company advertised was not a top choice of participants, in fact it did not even make the top three.

6. *Tier 3* is voluntary, and it may be in a form of a pension plan provided by employer, in which case, while contributions are not tax-deductible, benefits will be tax-free. Interestingly enough, since the fall of Communism, Poland has not had taxes on dividends and capital gains, thus this tax privilege seems spurious. However, the tax laws are being revised for EU entry, and taxes on investments are being implemented, therefore the relative attractiveness of *Tier 3* will be increasing. Also, while *Tier 3* contribution is treated as a wage expense to the employer, and

income to employee, it is not subject to the payroll tax for *Tier 1* and *Tier 2* mandatory pension contribution payroll tax, and those are quite substantial taxes indeed.

As of mid-2000, investment portfolios of pension funds consisted mostly of bonds (roughly 56 percent), shares listed at the Warsaw Stock Exchange (roughly 30 percent), with the rest mostly in cash equivalents and bank deposits. Pension funds face very severe restrictions on foreign content of their portfolios (no more than 5 percent) and on the use of derivative securities (no more than 5 percent). Both investment returns and internal results of pension plans in 1999 and 2000 have been discouraging. As a result of the 1998 Russian economic crisis, and subsequent restrictions on the cross-border trade with Russia and other non-EU nations east of Poland, Polish economy slowed its previously breathtaking (7 percent real) rate of growth, to about 5 percent real or less. Slower growth was also apparent in 2000. Performance of Polish capital markets in 2000 was mediocre at best, and pension funds have had negative returns up to date. On top of that, large advertising and marketing expenditures have hurt financial results of the pension companies. Yet these negative results have not been the main news in the early months of existence of the Poland's new pension system. As we had mentioned earlier, Polish reform called for the *Tier 2* contributions to be paid to ZUS and then forwarded to the private pension companies. It also called for *Tier 1* to be transformed into individual accounts. Yet ZUS has never created an individualized accounting system for contributions, and has not kept track of individual workers' contributions. In the traditional system in Poland, the worker nearing retirement had to secure an employment record from his or her current and former employers (and possibly universities, etc.), and such record was the basis for the pension benefit granted by ZUS. After all, the law did not base the pension on the contribution record, but on the employment record, and other special factors affecting the pension formula, given before. Yet in the new system, individual contributions are the key to determining the benefit level, and, even more importantly, account balance. What was not clear to the creators of the new reform was how unprepared ZUS was for such a major accounting change. Additionally, ZUS used to be able to count on general budget subsidy whenever it faced cash flows. But in 1999, the Government of Poland, and its Ministry of Finance, became very concerned with meeting EU entry fiscal requirements, and were hoping that the pension reform would release them from at least a part of the subsidy need.

The early stages of the reform brought about the exact opposite. State enterprises, especially the state railroad monopoly, dramatically delayed their pension contributions, ZUS was losing track of individual contribution amounts, and private pension companies, as well as their customers, were demanding their contribution money in pension accounts. The president of ZUS, Stanislaw Alot, facing those conflicting demands, and lacking appropriate subsidy from the budget,

decided to borrow money from ZUS line of credit with commercial banks. This caused mini-panic among retirees, and was promoted as a scandal by the media. While the credit cost was quite high, as credit is expensive in Poland, financial stability of ZUS was not endangered. But Stanislaw Alot quickly became the least popular politician in Poland, and was promptly replaced by Leslaw Gajek, professor of mathematics and an actuary from the Technical University of Lodz, a leading expert of the technical, modeling side of the reform (who was involved in, for example, resolving the issue of funding for special pension privileges for coal miners). Professor Gajek has succeeded in calming the storm, but the issue of improving the accounting and information processing systems at ZUS remains a serious one to this day, and contributions to *Tier 2* private accounts are still delayed. These problems are, ironically, much more an expression of the weaknesses of the old system than the new one, as they are the remnants of Communism which must be overcome, but they are an important reminder of the need to anticipate difficulties in the transition from a state pay-as-you-go system to a system of individual accounts, especially private ones.

Another issue that affected the public perception of the pension reform was the simultaneous implementation of three other major reform packages: health care, education, and national administration (Kolarska-Bobinska, 2000, provides a comprehensive review of this complex endeavor). While the reforms were badly needed, and instrumental in preparing Poland for its entry into the European Union, as well as for functioning in the global economy, the speed of their implementation, and the massive nature of having so many changes to manage by the government at the same time, have caused the public perception of the total reform process to be quite negative. The health-care reform was particularly troubled: many citizens' health or even life were endangered in the transition period. Poles viewed in horror news of victims of medical emergency whose health insurance coverage could not be verified, and thus their ambulance service or emergency care were denied. While these problems were eventually resolved, initial shock caused the Solidarity coalition government to sink in the opinion polls. The governing group will most likely be replaced by the social democrats in the 2001 election. The reforms were badly needed, but their implementation needed more political, and indeed humanitarian, skill.

One more issue has become significant as the reform matured. By the end of 2000 there were clear winners and losers among the newly created pension funds. At the end of November 2000, the largest funds were:

1. Commercial Union, holding PLN 23 billion (roughly US\$ 5 billion) for their customers,
2. Nationale Nederlanden, PLN 18 billion (US\$ 4 billion), and
3. PZU (former state insurance monopoly), PLN 13 billion (US\$ 3 billion).

At the other end of the scale, there were pension companies with rather small share of the market:

1. Rodzina, PLN 8 million (less than US\$ 2 million),
2. Kredyt Bank, PLN 23 million (US\$ 5 million), and
3. Polsat, PLN 30 million (US\$ 7 million).

As we see, the most successful company (and in addition to its pension success, Commercial Union enjoys equally dramatic success in the Polish life insurance and annuity market) has over thousand times larger asset base than the two smallest companies. Given huge marketing expenses of a nationwide pursuit of customers in a country of nearly 40 million, small companies are at a great disadvantage against the giants. On the other hand, this situation offers an interesting opportunity for the giants: expanding a customer base by acquiring a competitor may actually be cheaper than trying to peel them away in direct competition. This in turn has alarmed the chief regulator of the funds: Dr. Cezary Mech (2000). In an opinion piece in an influential Polish daily *Gazeta Wyborcza* he has come out strongly against the idea of inevitability of mergers among pension funds. Cezary Mech was also among the key authors of a major position paper put out by the *Office of the Superintendency of Pension Plans* called "Security Through Competition" (Polish Government, 2000). While Mech acknowledged temporary problems with transfers of funds from ZUS, in his opinion, and in the opinion stated in the position paper, Polish consumers face the greatest threat from lack of competition among pension funds.

Notably, at the end of 2000, *Office of the Superintendency of Pension Plans* received an application for approval of a takeover of Epoka pension plan by Pekao-Alliance SA fund. Given limited history of functioning of pension markets, and capital markets in general, regulators are very worried about a real possibility of a collusive oligopoly among pension funds. Mech has suggested some approaches in regulation to counter that threat: limiting the market share of a given fund to 15 percent of the market, and reducing or eliminating asset management fees collected by funds based on assets managed in favor of loads on initial deposits. The regulators are also very concerned about increasing incidence of using pension funds assets to acquire corporate control. Mech appears to be very critical of hostile takeovers by pension funds, insisting that instead such funds should be long-term investors, preferably with value investing style.

These points raised by the regulators are strongly challenged by former two chief architects of the entire reform: Dr. Marek Gora and Dr. Michal Rutkowski. They argue that mergers of pension plans represent merely a natural expression of winners acquiring losers in the competitive pension funds market. They also believe that asset management fees assessed on total assets under management are in fact the most competitive way of collecting fees, and this should be the chief way for

compensating pension fund management companies—this is clearly in direct conflict with the regulators. Interestingly enough, many American pension companies (e.g., Fidelity) are quite willing to waive initial sales charges, hopping to make greater long-term gains on asset-management fees.

It should be noted that the *Office of the Superintendency of Pension Plans* has wide supervisory role in the Polish system, and, given that it is a new body within the Polish government, its specific role is still subject to interpretation and possible legislative correction. In less than two year of this regulatory body's existence, twelve of the pension fund companies have brought appeals of its decisions to the court supervising it: the Supreme Administrative Court (*Naczelny Sad Administracyjny*). The court's decisions in such matters are final. Most of the cases are about administrative penalties assessed by regulators (13 funds were given such penalties, and their total amount approaches one million dollars). Other issues are not that unusual in the insurance industry: for example, the regulators objected to ten-year amortization schedule of certain advertising expenses by Skarbiec-Emerytura, a mid-sized company. The court actually sided with the pension fund, even though the regulators believed the cost should be expenses immediately (which, interestingly, is exactly the way such costs are expensed by insurance companies in the United States). Most advertising costs of Polish pension funds are, however, expensed immediately, as the regulators require.

Long-Term Perspectives

In 1995, not only was the ZUS subsidy overwhelming the general revenue budget (amounting to about 21 percent of it), but the long-term stability of ZUS looked very bleak. While long-term actuarial analysis was not required by law in Poland, it was essential for the political decision makers to familiarize themselves with long-term models for the purpose of structuring the reform. Insightful post-reform studies of long-term actuarial outlook of the pension system in Poland have been put forth by Gomulka and Styczen (1999). Their simulation results indicate that in the absence of the reform, already bad old system would have deteriorated significantly due to population aging. Ironically, Poland had developed a serious pension crisis *without* demographic problems. Nevertheless, the country does face the same long-term demographics as most of the developed world, eventually. Gomulka's and Styczen's simulations also indicate that as a result of the reform, state finances will improve considerably in the second quarter of the twenty first century. The new pension system has many natural stabilizers built in, and is in many ways market-based, thus providing a cushion from destabilizing influence of political lobbying.

The question of the long-term success of the new pension system is a deeper one. It is quite difficult for it to be addressed in simulations. We must keep in mind that major changes in policy have often unintended consequences, and socio-economic

processes have multilevel nonlinear dependencies, nearly impossible to predict. A very large portion of the pension system in Poland still remains under the state control, and while at this point it is not subject to lobbying, it may well be so in the future. Also, it is quite difficult to assess possible anti-selection in the *Tier 1*. The pension level in *Tier 1* is based on an actuarial estimate of life expectancy. But the remaining population receiving lifetime pensions may well be a select one, living beyond the estimate based on the overall cohort longevity. In the long run, the system may have to be adjusted, or even, at some distant point, reformed again. This new system, however, represents an unquestionable departure from state pricing of capital assets, and thus should help avoid unrestricted lobbying for benefits at the expense of the productive capacity of the economy.

Conclusions

Polish pension reform has been achieved as a result of a national debate, in the climate of openness, with a degree of tension, but with eventual consensus. This is a dramatic change for the formerly Communist totalitarian nation. Poland has succeeded in implementing major reforms in the 1990s with a fully functioning democratic political system in place. The new pension system also succeeds in addressing the key problems of the outdated system it replaced: it encourages work and savings, stabilizes public finances, and lowers the replacement ratio provided by the state pension without endangering poverty alleviation programs.

Its problems of implementation did not result from bad design of the new system, but rather from unexpected vestiges of old Communist bureaucracy. Nevertheless, those problems provide an important reminder of how difficult it is to anticipate consequences of major policy changes, and how often good policy is not enough in the political arena: it must be also implemented carefully and with political skill. Robert Peel had given Britain freedom from Corn Laws and Bobbies in the streets of London. In the long-run Britons appear grateful to him. In the short run, he was politically dead.

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