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Pension privatization and economic development in Central and Eastern Europe: A political economy perspective

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ABSTRACT:

A massive wave of pension privatizations has swept Latin America and Eastern Europe over the past three decades. This iconoclastic move went along with high hopes in terms of the impact of mandatory pre-funding on economic development. Most prominently, the World Bank's 1994 research report 'Averting the Old Age Crisis' had argued that mandatory prefunding would help countries to increase long-term saving, foster capital market deepening, and boost economic growth. Such expectations have long been contested on theoretical, empirical and normative grounds, not least by the UNRISD's research programme 'Social Policy and Development'.

Nevertheless, it has been shown that those macroeconomic promises amounted to a major driving force in the political economy of pension privatization in Latin America. Contrary to this, the interaction between pension privatization and economic development in Central and Eastern Europe (CEE) has received surprisingly little attention so far. Unlike Latin America, the region does not form part of the developing world and is far more prone to look to the West than to the South, but has engaged massively in radical pension reform. Beyond the theoretical, empirical and normative debate mentioned above, this paper takes a political economy approach to analyse the importance of economic factors and motives in the making of CEE pension privatization, taking a closer look at the cases of Hungary and Poland. In 1998 and 1999, respectively, those were the first EU8+2 countries to embark on pension privatization.

The paradigm shift that Hungarian and Polish policy makers embarked upon amounted to a deliberate break with social security traditions and with the pension policy of peer nations in the region. Its iconoclastic character notwithstanding, the move ended up creating an influential precedent in CEE. It should be noted that pension privatisation was only partial in both countries. Policy makers had opted for a mixed model with two mandatory tiers, thus combining a public pay-as-you-go tier and a private prefunded one.

This analysis of the interaction of economic factors and motives in the making of pension privatization in Hungary and Poland shows that macroeconomic considerations have indeed played a prominent role in CEE. As documented in the two case studies and the subsequent comparative analysis, economic aspects have impacted on the making of radical pension reform in three major ways, which are summarised in the following.

Pension reform, economic development and the transition: When setting out to reform their pension schemes, Hungary and Poland were in the midst of a fundamental transition from a state-led to a market-oriented approach to economic policy. Moreover, their plan to accede to the EU as soon as possible implied that they had considerable economic catching-up to do. Economic development and growth were thus clearly prominent issues on the political agenda in CEE at the time of pension privatization, as was the strengthening of the newly created capital and financial markets. This is one reason why Hungarian and Polish policy makers were susceptible to the macroeconomic promises of the advocates of pension privatization.

Economic arguments in the pension reform discourse: An analysis of the reform discourse in both countries shows that macroeconomic reasoning featured prominently in Hungarian and Polish pension reform. Pension reformers mainly hoped to achieve an increase in long-term saving, capital market deepening, and economic growth through prefunding. Although not all the economic arguments presented by pension reformers in Hungary and Poland are identical, the similarities in the patterns of reasoning are striking. Moreover, there are many parallels to the once-prominent World Bank discourse. The use of similar patterns of reasoning is no coincidence, but the result of an international transmission mechanism of ideas. The advocates of pension privatization have long formed a well-established epistemic community with shared discursive practices and a global radius of action, which also extended to CEE countries.

Economic issues in the political economy of reform: In the political economy of pension privatization proper, two types of economic issues – macroeconomic promises and economic emergencies – proved to be relevant. Both tended to reinforce the 'privatization faction'. The first set of issues encouraged the Finance Ministries in Hungary and Poland to push for pension privatization as a means to achieve their own macroeconomic objectives. Thus, what appeared to be a provocative strategy at first turned out to be useful in coalition building for pension privatization. The second set of issues included a crisis of the pension system, fiscal imbalances, an economic crisis, and high external debt. Those emergencies clearly tended to increase the stakes and leverage of those actors inclined towards pension privatization – the Ministry of Finance and the World Bank – in the local reform process. Taking both sets of issues together, it can thus be concluded that the constellation of actors in pension reform was changed significantly by economic issues, thus enabling pension privatization.

LIST OF ACRONYMS

AWS	Akcja Wyborcza Solidarność
CEE	Central and Eastern Europe
ÉT	Érdekegyeztető Tanács
EU	European Union
EU8+2	Central and Eastern European EU member states admitted on May 1, 2004 and January 1, 2007, respectively (Poland, Hungary, Czech Republic, Slovakia, Estonia, Latvia, Lithuania, Slovenia, Bulgaria and Romania)
GDP	Gross Domestic Product
IFIs	international financial institutions
IPF	individually prefunded
NDC	notional defined contribution
PSL	Polskie Stronnictwo Ludowe
PAYG	pay-as-you-go
SLD	Sojusz Lewicy Demokratycznej
UNRISD	United Nations Research Institute for Social Development
US$	United States Dollar(s)
USAID	US Agency for International Development
UW	Unia Wolności
ZUS	Zakład Ubezpieczeń Społecznych

1 INTRODUCTION

1.1 PENSION REFORM IN CENTRAL AND EASTERN EUROPE

Almost two decades have passed since the start of economic, political and social transformation in Central and Eastern Europe (CEE). The area of social security initially remained exempt from structural change. The scope and type of reforms needed were highly disputed, especially in the area of old-age security. Pension reform seemed inevitable in CEE, as the process of economic transformation was putting great strain on the existing retirement systems. However, there was considerable disagreement with regard to the paradigm to be followed in old-age security. Was it sufficient to make parametric changes to the existing public pay-as-you-go (PAYG) systems, or were private, individually prefunded (IPF) pension schemes a more appropriate solution?

In the late 1990s the first countries in the region decided to embark upon a paradigm shift in old-age security: pension privatization. Among the EU8+2 countries, Poland and Hungary were the first to embark on the paradigm shift.[2] In 1998 and 1999, respectively, those two countries opted for a mixed model with two mandatory tiers, a PAYG one and an IPF one. By so doing they followed a reform path that had already been tested by Latin American countries. Today, different variants of pension privatization have been legislated and/or implemented in more than 25 countries in Latin America and Eastern Europe (Müller 2006a; Orenstein 2008).

1.2 ECONOMIC ARGUMENTS IN THE DEBATE ON PENSION PRIVATIZATION

In their iconoclastic decision-making, most pension privatizers were encouraged and assisted by the World Bank. Publicized throughout the world, the Bank's well-known research report 'Averting the Old Age Crisis' (World Bank 1994a) intended to address a global problem with a universal formula – the multipillar model.[3] Interestingly, the Bank's pension reform strategy was not only driven by social policy considerations but also by macroeconomic desiderata. The

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[2] The so-called 'EU8+2' group of countries comprises Poland, Hungary, the Czech Republic, Slovakia, Estonia, Latvia, Lithuania and Slovenia that joined the European Union (EU) on May 1st, 2004, plus Bulgaria and Romania that followed on January 1st, 2007.

[3] The recommended multipillar system consisted of 'a mandatory publicly-managed tax-financed pillar for redistribution, a mandatory privately-managed fully-funded pillar for saving, and a voluntary pillar for people who want more protection for old age' (James 1997:4). However, the World Bank modified its approach a decade later. See Holzmann and Hinz (2005) for the Bank's current position.

duality of goals is highlighted by the report's subtitle 'Policies to Protect the Old and Promote Growth' (World Bank 1994a). Regarding the hierarchy of both types of objectives Estelle James, then one of the Bank's Lead Economists, argued that the multipillar model was to be introduced mainly for economic reasons:

> 'The chief theoretical argument for the recommended multipillar system is that it will have a positive effect on efficiency and growth … . A secondary argument is that it will enhance the financial sustainability of the old age system and thereby provide better protection for the old in the long run.' (James 1997:16)

Advocates of pension privatization, once aptly called the 'new pension orthodoxy' (Lo Vuolo 1996), tend to believe in the beneficial macroeconomic impact of the move, especially in 'the effects of a full or partial shift to a funded defined contribution plan on labor supply and its allocation, national saving and financial market development' (James 1997:30). The well-known World Bank report (1994a:22–23) argues that

> 'The mandatory multipillar arrangement for old age security helps countries to: … Increase long-term saving, capital market deepening, and growth through the use of full funding and decentralized control in the second pillar. … The broader economy should be better off in the long run as a result.'

Economic aspects discussed in more detail include implications for capital markets[4] – the impact of pension privatization on long-term saving, capital allocation and corporate governance – as well as implications for labour markets and, finally, fiscal implications (World Bank 1994a:208–216).

This kind of reasoning has been extensively debated and criticized by economists over the past fifteen years.[5] It also stirred considerable unrest among social security experts, who pointed to the danger that macroeconomic considerations crowd out social policy objectives when it comes to pension reform.[6]

> 'Ageing should not be used as an excuse to discredit and consequentially dismantle the existing social protection systems, in order to replace them by systems which serve a different purpose.' (Cichon 1995:14)

> 'The overriding objective of pension reforms, regardless of the model proposed, must be the improvement of retirement income security … A policy measure that has a positive impact on

[4] See also Chawla et al. (2007:138): 'Fully funded schemes invest most of their assets in securitized investments and therefore play an important role as institutional investors.'

[5] For a critical analysis see, e.g., Barr (2000), and Orszag and Stiglitz (2001). See also Hujo (2004).

[6] See, e.g., Queisser (1993), Kingson and Williamson (1996) and Schmähl (1998).

> … other areas but fails to improve the provision of pensions, should not be given the label of pension reform.' (Queisser 1998:15)

From a broader perspective, the United Nations Research Institute for Social Development (UNRISD) has stressed that the 'use of social policy as an instrument is unacceptable on principle, because it downplays the importance of social goals' (Mkandawire 2004:3). Rather, 'social policy can work in tandem with economic policy to lead to socioeconomic progress' (Mkandawire 2001: iii). While seeking to engender more policy coherence between the economic and social spheres, UNRISD (2007) also points to possible trade-offs and constraints inherent in this process.[7]

1.3 ECONOMIC ARGUMENTS IN THE POLITICAL ECONOMY OF REFORM

Beyond these normative debates and concerns, political economy analyses have shown that the macroeconomic promises ascribed to pension privatization were clearly a major driving force of the fundamental paradigm shift.[8] Those analyses were largely focused on the 'second-generation' pension reforms in Latin America, however. In those reforms, the cognitive availability of a precedent – Chile, featuring one of the subcontinent's strongest economies – played a major role.[9] After pension privatization had turned from a theoretical concept into a political reality, Latin American policy makers had compared their countries' economic performance to the Chilean success story, which they viewed as relevant to their own countries. Pension privatization, which was thought to engender strong macroeconomic effects, was widely considered as one of the ingredients of Chile's economic success.

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