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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.<sup>2</sup> 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.<sup>3</sup> 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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<sup>2</sup> 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.

<sup>3</sup> 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<sup>4</sup> – 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.<sup>5</sup> 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.<sup>6</sup>

'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

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<sup>4</sup> 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.'

<sup>5</sup> For a critical analysis see, e.g., Barr (2000), and Orszag and Stiglitz (2001). See also Hujo (2004).

<sup>6</sup> 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.<sup>7</sup>

### 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.<sup>8</sup> 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.<sup>9</sup> 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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<sup>7</sup> In particular, the UNRISD approach insists that ‘financing social policy should be concerned not only with efficiency, but also with equity, social cohesion and inclusion, as well as the more conventionally recognized social policy functions’ (Hujo and McClanahan 2007:2). In the context of the UNRISD research programme ‘Social Policy and Development’, see especially the flagship research project ‘Social Policy in a Development Context’ (2000-2005), which sought to stimulate interdisciplinary debate on the nexus between social policy and economic development, and the current research project on ‘Financing Social Policy’ (2005-2009), which seeks to explore one of the most important interfaces between social and economic policy.

<sup>8</sup> See, e.g., Madrid (2003), Müller (2003) and Weyland (2004).

<sup>9</sup> Other reasons that have been mentioned include the increase of international capital mobility, which may have motivated policy makers to seek to reduce the vulnerability to capital outflows by boosting domestic savings and strengthening local capital markets (Madrid 1998; James and Brooks 2001).



The political context of pension privatization in CEE was different, however. When pondering over their reform course in the mid-1990s, policy makers were far more prone to look to the West than to the South, given their aspirations at membership in the European Union (EU).<sup>10</sup> In public perception, less developed regions such as Latin America were deemed unsuitable as role models and irrelevant as benchmark cases.<sup>11</sup> Moreover, the connotations carried by the ‘Chilean model’ in CEE were more likely to refer to the Pinochet regime than to a relevant example of economic success. In how far was pension privatization thus related with issues of economic development in the CEE transition countries, now mostly new EU Member States?

In this paper, a political economy approach is chosen to analyse the importance of economic factors and motives in CEE pension reform. After this introduction, an overview provides the reader with some background information on pension systems and reform in the region. Thereafter, a closer look is taken at the cases of Hungary and Poland, the first EU8+2 countries to introduce mandatory private IPF tiers. Partial pension privatization in those two countries amounts to a deliberate break with the past and with the pension policy of peer nations, creating an influential precedent in the region. In each of the two case studies, the making of pension privatization is summarized before the economic arguments in the pension reform debate are presented. A comparative chapter then sets out to identify possible links between pension privatization and economic issues, and vice versa, in both countries. The paper’s main findings are presented in the concluding chapter.

## 2 BACKGROUND: THE PAST AND PRESENT OF PENSION REFORM IN CEE<sup>12</sup>

Bismarckian-style pension insurance was established in Central Europe at the end of the 19th century. The early schemes were fragmented and did not protect the rural population. During the socialist era, pension provision in Eastern Europe and the Soviet Union followed similar patterns. Pension schemes were unified and integrated into the state budget. Individual contributions were mostly abolished, rendering employers’ contributions the only source of financing. A major

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<sup>10</sup> Meanwhile, these aspirations turned into reality for ten countries of Central Europe, the Baltics and South-Eastern Europe, the EU8+2.

<sup>11</sup> It should be noted that some external experts thought there *were* lessons to be learnt from Chile – as one of the fastest growing economies in the world – for Central Europe (see, e.g., Sachs and Warner 1996).

<sup>12</sup> For more details see Müller (1999, 2006b).

achievement was the gradual expansion of coverage, rendering it virtually universal by the 1960s or 1970s. Overall, the existing contribution-benefit link was weak. Pensions depended on years of service rather than on contributions made. Although there was little benefit differentiation, branch privileges, amounting to a lower retirement age and higher benefit levels, were granted to occupations of strategic importance, marking an important departure from universalism. The insufficient adjustment of current pensions to price-wage dynamics implied that newly granted pensions were considerably higher than average retirement benefits, giving rise to problems of inter-cohort fairness and benefit adequacy.

Economic transformation, starting around 1989, affected the existing PAYG systems in several ways. At the onset of reforms, price liberalization and the curtailment of subsidies on basic goods and services implied a shift from indirect to direct transfers, requiring rising expenditure for old-age security. Subsequently, the restructuring of state-owned enterprises had an effect on both the revenue and expenditure side of public pension schemes. When state-owned enterprises were privatized, downsized or closed down, part of the workforce retired early, took out disability pensions or joined the mounting ranks of the unemployed. A simultaneous rise in the number of pensioners and fall in the number of contributors destabilized public pension finances, whereas plummeting formal employment also translated into sharply decreasing coverage ratios. The unemployed and underemployed face high and increasing poverty risk, being unable to make provisions for their old age, such as most informal sector workers. As noted by Chawla et al. (2007:152), '[a]lthough the vast majority of the region's elderly population collect pensions, the majority of the working-age population does not contribute to a pension system'. Differences in level and scope of old-age protection are thus widening, both within and among transition countries.

Reflecting those ongoing labour market transitions, system dependency ratios are deteriorating dramatically. However, high dependency ratios also arise from demographic ageing affecting the region (Chawla et al. 2007; Münz 2007). By the mid-1990s, it had become clear that the old-age pension systems inherited from the socialist past were undoubtedly in dire need of reform. Two basic reform paths can be differentiated in the region, parametric reforms and pension privatization. Those two paths will be presented in the following, with a focus on the latter.

Parametric changes to the existing retirement schemes were relatively undisputed among social security experts and included the separation of pension schemes from other social insurance plans

and from the state budget, the introduction of an employees' contribution, the raising of the retirement age, the abolition of branch privileges, the restriction of early retirement, the tightening of eligibility for invalidity pensions and the introduction of indexation rules to provide protection against inflation. Several postsocialist countries opted for another potentially costly move when linking benefits closer to lifetime earnings in order to improve contribution incentives, e.g. by introducing German-style pension points or notional defined contribution (NDC) plans. The German point system implies a close contribution-benefit link. One earnings point is acquired for each calendar year in which individual earnings equal the national average. Benefit calculation is essentially based on the sum of all earnings points, thus reflecting the entire labour biography. Contrary to this, NDC schemes integrate the logic of a prefunded tier into the public one. All contributions paid to the public scheme are recorded on individual accounts, yet capital accumulation is only virtual. Individual benefit levels essentially depend on the sum of individual contributions, while also reflecting the remaining life expectancy at retirement and the chosen retirement age (Cichon 1999; Holzmann and Palmer 2006).

Starting from the late 1990s, an ever-increasing number of transition countries, among them eight out of ten new EU member states (EU8+2), opted for a more radical approach: full or partial pension privatization. This radical move can take three forms: substitutive, parallel or mixed (Mesa-Lago 1998).<sup>13</sup> However, the parallel approach is non-existent in the region, and only Kazakhstan and Kosovo opted for the substitutive approach. A mixed system, clearly the dominant choice in the region, was introduced in Hungary, Poland, Slovakia, Latvia, Estonia, Lithuania, Bulgaria, Croatia, Macedonia and Romania. A number of other countries in the region are also considering a partial shift to funding.

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<sup>13</sup> Under the substitutive model, the former public system is closed down, being replaced by a privately run IPF scheme. The parallel approach implies that a private IPF system is introduced as an alternative to the public one, resulting in two competing pension schemes. Under the mixed model a newly created mandatory IPF tier complements the reformed public system. The first country to introduce this variant was Argentina, in 1994, which is now backpeddling.

Table 1 Overview on pension privatization in the EU8+2 countries

	Hungary	Poland	Latvia	Bulgaria	Estonia	Lithuania	Slovakia	Romania
Public tier	Traditional PAYG	NDC	NDC	Pension points	Traditional PAYG	Traditional PAYG	Pension points	Pension points
	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory
Private tier	Prefunded	Prefunded	Prefunded	Prefunded	Prefunded	Prefunded	Prefunded	Prefunded
	Mandatory for new entrants to the labour market; optional for all others	Mandatory up to age 29; optional between ages 30 to 49	Mandatory up to age 29; optional between ages 30 to 49	Mandatory up to age 42	Mandatory up to age 18; optional for all others	Optional for all insured	Mandatory for new entrants to the labour market; optional for all others	Mandatory up to age 35; optional between ages 35 to 44
	8 per cent individual contribution rate	9 per cent individual contribution rate	Individual contribution rate will increase to 10 per cent	Contribution rate will increase to 5 per cent (including employers' share)	Individual contribution rate: 2 per cent + employers' contribution: 4 per cent	5 per cent individual contribution rate	9 per cent employers' contribution	Individual contribution rate will increase to 6 per cent
	since 1998	since 1999	since 2001	since 2002	since 2002	since 2004	since 2005	since 2008

Note: Age thresholds are indicated as of the year of reform introduction.

Sources: Müller (2006b); OECD (2007); SSA (2007); Romania News Watch (2008).

Chilean-style substitutive pension reform was implemented in Kazakhstan (1998), which is, strictly speaking, not a CEE but a Central Asian country. All Kazakh workers, regardless of their age, were required to contribute 10 per cent of their gross wage to one of the newly set-up pension funds. In Kosovo, all workers and their employers are jointly contributing 10 per cent of wages to individual accounts at the Kosovo Pension Savings Trust, an independent institution (2002-2003).

Most countries in the region introduced a multi-tiered structure, however. Argentine-style partial pension privatization was chosen in Hungary (1998), Poland (1999), Latvia (2001), Bulgaria, Croatia, Estonia (2002), Lithuania (2004-2005), Slovakia (2005), Macedonia (2006) and Romania (2008). In these countries, the post-reform pension system is of a mixed type, combining a mandatory public PAYG tier with a mandatory IPF system.

Table 1 shows that the mixed model was chosen by all EU8+2 countries but the Czech Republic and Slovenia.<sup>14</sup> The first, PAYG tier is mandatory for all insured and covers past and future pension claims acquired in the public pension scheme. The second tier is designed as a decentralized prefunded scheme, run by competing private pension funds in charge of account and asset management. Upon retirement, the calculation of annuities is based on the total amount of accumulated funds and the remaining life expectancy of the insured.

The second tier is financed by a contribution rate of 2 to 10 per cent, to be diverted from the first tier. Pension privatization usually implies that contributions to the newly created individual accounts are financed entirely by employees to strengthen the idea of individual responsibility for old-age provision. However, policy makers in Estonia and Bulgaria have recently opted for a co-financing of both mandatory tiers by employers' and employees' contributions, and in Slovakia employers even pay the entire second-tier contribution.

Membership in the second tier is usually a question of age and/or choice. Poles and Latvians aged 50 and over, Romanians aged 45 and over, and Bulgarians aged 43 and over were required to remain in the old system. However, Poles and Latvians under age 30 and Romanians up to age 35 were obliged to join both mandatory tiers. Those between 30 and 49 (Poland, Latvia) or between 35 and 44 (Romania) could do the same or stay in the old public scheme. In Hungary and Slovakia, all new entrants to the labour market were obliged to join the new scheme, while all others who were not yet retired could choose the purely public or the mixed option. In Lithuania, all workers may opt to participate in the second tier,

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<sup>14</sup> See Müller (2002) on pension reform choices in the Czech Republic and Slovenia.

regardless of their age, but are not obliged to do so. Contrary to this, all Bulgarians up to age 42 were required to join the second tier.

Currently, the new schemes thus offer a purely public as well as a mixed pension option on an optional, partially optional or mandatory basis. However, given that both the young and new entrants to the labour market are obliged to participate in the second tier, the future pension system will contain a mandatory prefunded component for all. Only in Lithuania may future insured continue to choose the purely public option.

Table 2 Affiliates and capital stock in the second tier, EU8+2 countries (as of 31 December 2006)

	Affiliates to the second tier		Capital stock in the second tier	
	Thousands	Per cent of employed persons	US\$ million	Per cent of GDP
Hungary	2,652	69	7,797	6.3
Poland	12,353	95	40,049	11.1
Latvia	900	82	237	3.9
Bulgaria	2,443	77	478	1.8
Estonia	520	80	646	3.6
Lithuania	780	52	344	4.0
Slovakia	1,540	72	1,069	1.7

*Sources:* HFSA (2007), FKTK (2007); FSC (2007); KNF (2007), LSC (2007), NBS (2007), Pensionikeskus (2007); own calculations.

Table 2 shows that by the end of 2006, more than two thirds of all employed persons were affiliated to the second tier in most EU8+2 countries. Even in Lithuania, where participation is entirely optional, 52 per cent of all employed persons joined the second tier. With 12.4 million affiliates, the number of fund members was highest in Poland, which is the largest country in the region and one of the earliest reformers. In contrast, the number of affiliates was below one million in the small Baltic States (Estonia, Lithuania, and Latvia). With US\$ 40.0 million in assets or 11.1 per cent of Gross Domestic Product (GDP), populous Poland also featured first in terms of the accumulated capital stock, followed by Hungary. Second-tier assets amounted to less than 2 per cent of GDP in Slovakia, a recent reformer, and in Bulgaria, where wage levels are low and contribution rates to the prefunded tier were initially only fixed at 2 per cent. Thus, only ten years after the start of pension privatization in the region, some economic implications of the move are clearly visible.

### 3 THE CASE OF HUNGARY

#### 3.1 THE MAKING OF PENSION PRIVATIZATION IN HUNGARY<sup>15</sup>

Hungary's transition to democracy was negotiated in 1989. The free parliamentary elections of 1990 produced a centre-right coalition government (1990-94), led by József Antall who chose a gradual approach to economic reforms. The 1994 elections were won by the postcommunists, who set up a coalition with the Free Democrats. The socialist-liberal coalition led by Gyula Horn (1994-98) controlled 72 per cent of seats in Congress. By that time, the country faced large fiscal and current account deficits, while foreign debt was on the rise. When the country suffered a sharp loss in credit standing, there were fears that the crisis that hit Mexico in December 1994 could spread to Hungary. In March 1995, Finance Minister Lajos Bokros reacted to this scenario by launching a drastic adjustment package (Kornai 1997). The Bokros package proved to be extremely controversial, triggering a series of strikes. A number of measures were even stopped by the courts. After Bokros' resignation in February 1996, the new Finance Minister, Péter Medgyessy, opted for a less confrontative style. Yet, he essentially held the line and accelerated the structural reforms initiated earlier, including radical pension reform (Bokros and Déthier 1998).

Hungary's iconoclastic pension reform implied a significant reprioritization between public and private retirement provision, even though the public tier continues to play an important role. It is interesting to note that the first pension privatization in Central Europe was enacted and implemented by a government led by postcommunists. After their election victory, the overall policy context – a rising external debt burden, a near currency crisis and a drop in credit standing – forced the centre-left coalition to demonstrate its commitment to market-oriented reforms. While the Bokros package was intended as an emergency measure, it can be argued that Hungarian policy makers opted for pension privatization to signal their ongoing resolve to tackle outstanding structural reforms. Hungary's credit rating from Moody's improved after partial pension privatization, in spite of the fiscal costs of the move (James 1998).

Thorough parametric reform had proved hard to implement in the early 1990s, and the public pension scheme exhibited a persistent deficit. The PAYG system's dependence on budgetary subsidies granted the Ministry of Finance an important stake in pension reform. Effectively, an economic emergency and the financing needs of the public pension scheme significantly changed actor constellation in the Hungarian pension reform arena. After this principal ally of

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<sup>15</sup> For a detailed discussion see Müller (1999, 2003).

the ‘new pension orthodoxy’ had been strengthened, he could outweigh the Welfare Minister’s opposition. The Finance Minister also took the lead in pension reform preparations by setting up the reform team in his Ministry.

Clearly, agenda-shifting in Hungarian old-age security was facilitated by the World Bank. Given the country’s external debt burden, piling up in the 1970s and 1980s, the international financial institutions (IFIs) were important players. While the Bank’s early advice had been limited to reforms within the existing public PAYG scheme (World Bank 1992), its campaign for pension privatization in the region started shortly afterwards.<sup>16</sup> At the request of the Ministry of Finance, the Bank’s Budapest office became directly involved in the Hungarian pension reform around 1995 (Palacios and Rocha 1998). World Bank experts were careful not to take an active role in public discussion. Support was provided through a Public Sector Adjustment Loan and through the Pension Administration and Health Insurance Project, which had been operating in the public tier since 1993. Clearly, the Bank’s involvement aimed at creating a precedent: ‘Once one country in the region introduces a successful multipillar system, others are likely to follow suit quickly’ (World Bank 1994a:291).

The extraordinarily quick passage of the pension reform laws in Congress was not only due to the governing coalition’s strong parliamentary majority, but also to pre-legislative negotiations with relevant opponents over the pension reform draft, most notably the trade unions. In a corporatist policy style, Congress had conditioned its approval of the pension laws to the consent of the tripartite council, *Érdekegyeztető Tanács* (ÉT). It should be noted, however, that the reformers were only willing to compromise on first-tier reforms, while their basic paradigm choice – partial pension privatization instead of a mere parametric reform – was not put up for discussion (Müller 1999). Eventually, advocates of pension privatization got their envisaged precedent: ‘Passage of the Hungarian pension reform by Parliament has demonstrated the political and economic feasibility of this type of reform in Central Europe’ (Palacios and Rocha 1998:213).

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<sup>16</sup> The Bank’s reform recommendations to the Hungarian government implied a ‘systemic change, involving splitting the current single public scheme into two mandatory pillars – a flat citizen’s pension and a ... fully funded second pillar’ (World Bank 1995:38–40). Around the same time, a full privatization of Hungarian old-age security had been proposed by an outside observer: ‘By replacing Hungary’s bankrupt retirement system with a private pension system, Hungary’s rapid and equitable transition to a market economy would be easier. With the new private pension system, Hungary could evolve retirement policies that society can afford, that satisfy the diverse needs of the elderly, and that support a healthy and expanding economy.’ (Chung 1993:84)



### 3.2 ECONOMIC ARGUMENTS IN THE HUNGARIAN PENSION REFORM DEBATE

The first comprehensive pension reform proposal in postcommunist Hungary dates back to 1991, when Parliamentary Resolution No. 60/1991 endorsed a three-tier approach that did not involve pension privatization, comprising one voluntary private tier and two mandatory public tiers (Czúcz 1993; CCET 1995). This early blueprint was never turned into practice, except for the voluntary tier: introduced in 1994, it amounted to the first diversification of Hungarian old-age provision. Third-tier institutions were set up as mutual benefit funds, i.e. non-profit organizations owned by fund members themselves. This type of corporate design was important, as it enabled reference to ‘solidarity’ as one of the basic principles, alongside ‘self-provision’ (Ministry of Finance 1994:9). Interestingly, the introduction of the Voluntary Mutual Benefit Funds was also driven by macroeconomic considerations:

‘[B]y expanding the sources available for long-term investment they promote the development of the Hungarian capital market’ (Ministry of Finance 1994:9).

A government decree reopened the case for comprehensive pension reform in December 1994 by setting up the Committee of the Reform of the Treasury. In June 1995 one of its seven subcommittees, the Subcommittee on Social Welfare, called for a thorough restructuring of the existing public PAYG scheme that was to remain the only mandatory tier. By and large, this proposal met with approval from the Committee of the Reform of the Treasury (Czúcz and Pintér 2002; Ferge 1999). Only a few weeks later, however, the Committee – directed by the Minister of Finance – surprisingly presented a fundamentally different pension reform concept to the Hungarian government. The first version of this blueprint, presented by Finance Minister Bokros, suggested a full privatization of Hungarian old-age security, following the Chilean precedent.<sup>17</sup> It soon turned out that Chile was not a politically palatable role-model for Hungary, however (Ferge 1999; Orenstein 2000).<sup>18</sup>

Hence, the share of public old-age provision to be privatized was lowered from 100 per cent of contributions to 50 per cent, with the reform approach changing from the substitutive to the mixed type (see Chapter 2). The proposed system would ‘retain an important role for the state and, at the same time, would develop more possibilities for the private sector’ (Rocha 1996:15). Among the reasons for this conceptual modification, fiscal considerations also featured prominently. The level of Hungary’s implicit pension debt would have implied

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<sup>17</sup> Similarly, see Chung (1993).

<sup>18</sup> For example, a trade union conference held in Budapest regarded ‘the introduction of the system developed for South[-A]merican countries, such as Chile, a dangerous exercise’ (Autonóm Szakszerveetek et al. 1996:1).

extremely high transition costs, had reformers stuck to the substitutive approach (Orenstein 2000).

Though heavily contested, the Ministry of Finance's blueprint was presented to the public as the 'single valid solution' (Ferge 1999:237). The local followers of the 'new pension orthodoxy' and their international allies stressed that the existing public PAYG scheme was financially inviable and 'could explode' in the next decade (Rocha 1996:14). Contrary to this, the proposed model – partial pension privatization – was thought to carry macroeconomic and other advantages, as illustrated by the following quote from a newspaper interview:

'This scheme is balanced, could ensure a nice income at retirement, and could contribute to economic growth as well. It would encourage savings and plough them back into the economy.' (Rocha 1996:15)

In the World Bank's view, the Hungarian pension reform was to achieve three objectives, among which:

'to enhance Hungary's future growth performance by promoting national savings, developing capital markets, and reducing distortions in the labor market' (World Bank 1999a:14).

'In Hungary's present economic situation, there is much to argue for the creation of a fully funded second pillar – especially the incentives for greater savings, and the dynamic effect on capital markets. ... Channeling progressively large sums into a whole new generation of institutional investors, with very long-term investment horizons and relatively low liquidity needs in the short and medium terms, would be a major boost to stock and bond markets. It would also spur investment and potential output growth.' (World Bank 1995:39–40)

The Finance Ministry's 1995 proposal was criticized by the Hungarian advocates of Bismarckian-Beveridgean traditions, who argued that 'the problems of the Hungarian pension reform can be solved without a forced paradigm shift. ... We suggest to give European type answers based on our own historical traditions' (Bod 1995:174). The Subcommittee on Social Welfare, the Self-Government of the existing PAYG pension scheme, and the Ministry of Welfare developed their own reform proposals<sup>19</sup> and rejected pension privatization:

'The quotation of Latin American examples does not prove its assumed positive effect with regard to revival of the economy. At the same time its individual, social and budgetary consequences seem clearly negative' (Augusztinovics and Martos 1996:157).

The stalemate between the Ministries of Welfare and Finance on pension reform was settled in April 1996. Four weeks later, a joint reform blueprint by the Ministries of Welfare and Finance was presented. The new concept strongly resembled the Finance Ministry's earlier

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<sup>19</sup> For an overview of the reform proposals of the Bismarckian-Beveridgean faction see Müller (1999).

proposal. Yet, the share of public old-age provision to be privatized had been decreased from 50 to 30 per cent of contributions (Ministry of Welfare and Ministry of Finance 1996; Ministry of Finance 1997). In their proposal, the Ministries of Welfare and Finance argued:

‘The system with mixed financing is expected to have positive effects on the economy by encouraging savings:

- firstly, the individual capital accounts ... diminish the distortions of the labor market, as they provide less motivation to the managers and em[p]loyees to turn to the hidden economy and encourage employment in the formal sector,
- secondly, a fully funded element results in a significant new demand for the long-term financial investment, therefore helps the development of capital market, the financing of new investments,
- thirdly, the reform will expectedly result in higher savings in the national economy, as the transition is financed not only from government debt, but partly from the savings generated through reasonable pension benefit payments in the reformed pension system.

These three advantages shall obviously result in growing Hungarian output, the gross domestic product. The social insurance reform may lead to radical improvement in the domestic capital accumulation. ... The development of the capital markets may significantly contribute to the growth of the national economy. ... The relation between savings and economic growth is empirical evidence [sic!].’ (Ministry of Welfare and Ministry of Finance 1996:9–10)

Soon after the inter-ministerial agreement, a pension reform committee led by István Györfi, a Commissioner to the Minister of Finance, was set up, thereby bypassing the exclusive competences of the Ministry of Welfare. The reform team was actively supported by the World Bank’s resident mission in Budapest. As part of their collaboration, Bank staff simulated the impact of the Hungarian multipillar reform and concluded:

‘If fully implemented, these measures would generate some increase in national savings, foster the development of capital markets, and reduce the distortions in labor markets. These results would contribute to an improvement in Hungary’s growth performance, although it is admittedly difficult to quantify their impact.’ (Palacios and Rocha 1998:209)

## 4 THE CASE OF POLAND

### 4.1 THE MAKING OF PENSION PRIVATIZATION IN POLAND<sup>20</sup>

Poland’s partially free elections of June 1989 had led to a sweeping victory of Solidarity, in the midst of an ever-worsening economic crisis, combined with hyperinflation. In cooperation with an IMF team and a group of international advisors – among them Jeffrey Sachs – the Finance Minister, Leszek Balcerowicz, developed a radical reform package. The country suffered from a high level of external debt, and the chances for its reduction ‘depended on

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<sup>20</sup> For a detailed discussion see Müller (1999) and (2003).

Poland's adoption of a comprehensive and radical economic programme, which was in any case required on domestic grounds' (Balcerowicz 1995:319). At that time, strong government, public and international support for reform had created a window of opportunity for far-reaching reform (Landau 1997).

However, the social costs of the programme proved to be larger than expected, translating in unstable governments and a slow-down in the pace of reform. The 1993 elections granted the postcommunist *Sojusz Lewicy Demokratycznej* (SLD) and the agrarian *Polskie Stronnictwo Ludowe* (PSL) a two-third's majority in Congress. Increasingly vocal constituencies and economic recovery complicated the continuation of reform, but did not reverse Poland's commitment to a market-oriented course. Economic reformers were successively appointed Ministers of Finance, while also holding the position of Deputy Prime Minister for extra leverage. In 1994, Poland was assisted by the IFIs in settling its massive debt to private banks, thereby restoring access to international financial markets. After the 1997 elections, a short-lived coalition of Solidarity's political wing, *Akcja Wyborcza Solidarność* (AWS), and the small liberal *Unia Wolności* (UW) held a 61 per cent majority of seats in Congress. They set out to tackle the remaining agenda by launching a package of four major reforms in 1999, which included structural pension reform (Szczerbiak 2001).

The partial privatization of Polish old-age security amounts to a significant departure from local social insurance traditions. Due to the introduction of a NDC scheme (see Chapter 2), Polish first-tier reforms were also more sweeping than the ones enacted in Hungary. When this reform was being prepared, the severe transitional crisis was already over, although fiscal imbalances persisted. It was argued that the pension system had become 'the most important source of the budget deficit; had the pension system been balanced, Poland could have run fiscal surpluses in 1990-96' (World Bank 1997:72). As parametric reforms had proved politically difficult, pension privatization came to be considered as an alternative. It should be noted that by that time Poland was severely indebted (World Bank 1996).<sup>21</sup> Although important progress had been made towards a reduction of the debt burden, the country was still closely monitored by its creditors, who expressed concern about the slow-down of reforms after the Balcerowicz Plan. By the mid-1990s, pension privatization was much recommended by the World Bank and soon turned into a key element on Poland's outstanding agenda of structural reforms (World Bank 1997).

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<sup>21</sup> It was only in the second half of the 1990s that Poland's status changed from 'severely indebted' to 'less indebted' (World Bank 2001).

Pension privatization was initiated by an ‘unlikely’ postcommunist government, facing a special need to signal its commitment to market-oriented reforms and fiscal sustainability.<sup>22</sup> In spite of its overall critical reception, pension privatization did appeal to the Finance Minister and Deputy Prime Minister, Grzegorz Kołodko. The fiscal impact of the deficit produced by the Social Insurance Institute, *Zakład Ubezpieczeń Społecznych* (ZUS), turned him into a key actor in the pension reform arena, and he emerged as the winner from a conflict with the Labour Minister, Leszek Miller, on pension privatization.

Thereafter Miller’s successor, Andrzej Bączkowski, took a lead in the pension reform project. Polish reformers managed to build a cross-party consensus on the need for structural pension reform, allowing for a continuation of the unfinished legislative agenda in spite of the 1997 government change. The political alternatives were clearly less attractive: a continuation of the high subsidies to ZUS at the expense of other government expenditures, or drastic retrenchment in the public pension system – a politically sensitive if not impossible move, given that the Constitutional Court had effectively vetoed modifications of acquired pension entitlements (Hausner 2001).

As regards the first tier, the Polish reform is clearly inspired by the earlier Latvian and Swedish reforms with their NDC approach, while its mixed overall structure much resembles the Argentine reform of 1994. World Bank advice amounted to a major channel of transmission of the Latin American precedents. The Polish pension reform team was headed by Michał Rutkowski, a World Bank economist on leave, granting the Bank a pivotal chance to support the Polish pension reform with international networking as well as technical and financial assistance (Kavalsky 1998; Nelson 2001). The World Bank and the US Agency for International Development (USAID) sponsored trips of Polish social security experts, journalists, trade unionists and members of parliament to Argentina and Chile. Moreover, individual Latin American reformers passed their experiences on to Polish policy makers.<sup>23</sup> However, the Polish reformers resorted to ‘tactical packaging’, distancing themselves from the Latin American precedents (see, e.g., Rutkowski 1998).

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<sup>22</sup> For the credit that the move earned see World Bank (1999b:10): ‘Poland can take pride in the fact that it is one of a limited number of countries which has successfully launched a complete restructuring of its social security system.’

<sup>23</sup> A prominent example is the Polish edition of Piñera’s 1991 book (Piñera 1996), with a preface entitled ‘Let’s learn from the Chileans!’ (Wilczyński 1996). See also Schulthess and Demarco (1995) and Zabala (1995).

Pension reform was legislated by the only two subsequent post-1989 governments with large majorities in Congress. Nevertheless, policy makers did not opt for mandatism, but for parliamentarism and concertation, negotiating with the opposition in the legislature and beyond, yet only compromising on first-tier reforms, not on pension privatization.

#### 4.2 ECONOMIC ARGUMENTS IN THE POLISH PENSION REFORM DEBATE

In the 1990s, a number of proposals for a comprehensive reform of the Polish pension system were presented. As early as 1991, mandatory pre-funding had been recommended by two Polish social security experts (Topiński and Wiśniewski 1991).<sup>24</sup> In that blueprint economic considerations featured prominently, as the authors sought to develop the Polish capital market, improve the financial and economic literacy of the population, and foster the privatization of state-owned enterprises:

‘Such a reform would have a great effect on the capital market. Pension funds are the principal sources of support for capital markets in many countries and, on account of their long-term character, they work to stabilise the market. This could be a most important function of pension funds in the first few years of the capital markets’ operation in Poland. ... This would introduce an institutional system for the collective investment of personal savings, playing an important role in economic education in society, giving the public an entrance into the capital-financial markets and ensuring greater control of the privatisation of the economy. ... The proposed solutions are fundamental to any consideration of a programme of privatisation.’ (Topiński and Wiśniewski 1991:5–6)

In the early 1990s this recommendation was, however, widely considered too radical.<sup>25</sup> It was only in 1994 that the authors managed to gather a like-minded audience for their proposal. This was at a conference in Warsaw, mainly attended by social security experts with an economic background (Topiński and Wiśniewski 1995). At the conference, a special section with five papers was devoted to ‘Capital Market Development and Pension Funds’ (IPiSS and Institute for East West Studies 1995:126–164).

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<sup>24</sup> Topiński and Wiśniewski (1991) proposed a two-tiered system. A PAYG tier, mandatory for all, would insure the individual’s salary up to a threshold of 120 per cent of average earnings. Individuals would be required to pay contributions on earnings above this threshold into a private IPF scheme. Wojciech Topiński had been President of ZUS in 1990/91 and had become acquainted with pension privatization during a visit to Chile.

<sup>25</sup> For an in-depth analysis of the Topiński-Wiśniewski proposal in the light of the Chilean experience see Diamond (1994). See also Maret and Schwartz (1994:79–81) and Apolte and Chomiuk (1995) for a discussion of Chilean-type proposals for Poland.

Meanwhile, the World Bank had also recommended the medium-term introduction of a mandatory prefunded pillar in its 1993 country study (World Bank 1993).<sup>26</sup> This was even before the publication of its universal pension reform blueprint in 1994. Compiled by Nicholas Barr, later a prominent critic of the Bank's global pension privatization campaign, the country study cautions on the contribution of pre-funding to economic growth but points to other economic advantages:

‘This line of argument does not deny the important role of pension funds in channelling savings into productive investment. ... They appeal to individual responsibility, improve consumer choice, assist the development of capital markets and may eventually have a beneficial impact on public expenditure’ (World Bank 1993:88–89).

In its 1994 country study, the Bank proposed a gradual move toward a multi-tier system, consisting of two public tiers – a basic flat-rate social assistance tier and an income-related defined benefit tier – and a private IPF tier. All three tiers were to be mandatory (World Bank 1994b:36–38).<sup>27</sup> Economic considerations feature prominently in this proposal, as illustrated by the following quotes:

‘These reforms could help strengthen public finances, develop capital markets, and provide new vehicles for private savings.’ (World Bank 1994b: xii)

‘There are several compelling arguments why a funded component of a multi-tier system would be appropriate in Poland. It would (a) increase personal incentives, (b) control public spending, (c) support capital and financial markets, (d) reduce inflationary pressures by increasing personal savings, and (e) increase public resources available for poverty relief.’ (World Bank 1994b:36)

The proposed shift to pre-funding also appealed to the Polish Ministry of Finance. Shortly after assuming office in April 1994, Finance Minister Kołodko announced a transition to a prefunded pension scheme in his so-called ‘Strategy for Poland’, an important policy document (Kołodko 1996:63). Subsequently a blueprint for pension privatization was prepared by Marek Mazur, an advisor to the Ministry of Finance.<sup>28</sup> Mazur's proposal was never formally submitted to government, but had considerable paradigmatic impact. Regarding potential economic effects, the author expected a positive effect on the Polish

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<sup>26</sup> ‘In the medium-term, ... [t]here should be a mandatory system of private pensions, subject to state regulation’, alongside a basic state-run social insurance and a voluntary third pillar (World Bank 1993:100).

<sup>27</sup> The new pension system was to start only in 2010, considering Poland's economic and political conditions (World Bank 1994b).

<sup>28</sup> Mazur, acquainted with the precedents after a study trip to Latin America, designed a parallel old-age system in which the insured were to be given a choice between a reformed ZUS and a newly created system of private IPF pension funds (Mazur 1996).

labour market, as the informal sector was to be reduced and work incentives were to be strengthened. Moreover, it was claimed that pension privatization might result in an acceleration of economic growth (Mazur 1996:26).

Soon, a polarised debate was unleashed about the pension reform strategy to follow in Poland.<sup>29</sup> On one side, the Ministry of Finance and some social security experts, mainly economists, advocated pension privatization. They were supported by the financial sector, mainly insurance companies and banks, as well as the World Bank. In 1995, the Solidarity trade union also joined the ranks of the advocates of mandatory pre-funding, ascribing the following macroeconomic advantages to it:

‘From an economic point of view, long-term pension insurance schemes based on capitalised contributions have a huge effect on a country’s economy because they boost the level of saving, and reshape it with active resources channelled through the capital market’ (Lewicka et al. 1996:56–57; own translation).

On the other side, the Ministry of Labour (until a cabinet reshuffle of February 1996) and a group of social security experts, mainly with a background in social insurance law, stressed the potential inherent in the existing PAYG pension system. In their view, a thorough reform of ZUS was sufficient.<sup>30</sup> A radical regime change in old-age security was thought not only superfluous but also detrimental, as it threatened to destroy social solidarity (e.g. Jończyk 1997). Moreover, the macroeconomic arguments presented by the supporters of pension privatization were criticized:

‘According to their advocates, pension funds increase national saving and stimulate economic activity. This is, however, a very doubtful hypothesis, not only on theoretical grounds. There is no proof either that pension funds accelerate economic growth in those countries where they already exist.’ (Wóycicka 1997; own translation)

After the resolution of the stalemate between the Ministries of Finance and Labour, a rough outline of the government’s pension reform plan was published in October 1996. The proposal had been prepared by the Office of the Government Plenipotentiary, a special task force for pension reform: a reformed, down-sized ZUS was to be supplemented with a mandatory private prefunded tier.<sup>31</sup> In February 1997, a hundred-page report provided detailed information on the reform, coining the catchy slogan ‘Security through Diversity’ (Biuro 1997; Office 1997). Security of old-age pensions was presented as the main aim of the reform, and diversification of retirement income – through the various tiers of the pension

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<sup>29</sup> For details see Golinowska, Czepulis-Rutkowska and Szczur (1997), Golinowska (1999) and Hausner (2001).

<sup>30</sup> For an overview of the specific reform proposals of the Bismarckian-Beveridgean faction see Müller (1999).

<sup>31</sup> See A.F.T. (1996), Biuro (1996) and Koral (1996).



system – as the means to achieve it (Żukowski 1999:160). A short version for citizens entitled ‘Your pension – Security through Diversity’ prominently refers to macroeconomic issues, namely in the first out of ten ‘principles, or safety devices’ (Pełnomocnik Rządu 1997:8):

‘First of all, the construction of the system and the mechanism of its operation create the conditions for a lasting and balanced economic growth, which amounts to the most reliable and an absolutely necessary condition for security.’ (Pełnomocnik Rządu 1997:8; own translation)

Moreover, the reform team expected pension privatization to increase saving, foster capital market development and facilitate enterprise privatization:

‘Accelerated economic growth cannot be unambiguously attributed to the functioning of pension systems. ... Nevertheless, there are observable phenomena due to the introduction of private pension funds. ... The basic issue to consider is the level of savings in the economy. ... Long-term savings appear, creating demand for long term securities in the capital markets. ... New financial institutions appear, offering new instruments, making financial markets more competitive and lowering the costs of capital. The creation of funded pension funds allows acceleration of privatization due to the large amount of money accumulated in the funds. Creation of the funds also leads to a significant increase in capital markets size in countries implementing these reforms.’ (Office 1997:50–51)

Simultaneously, a World Bank Country Economic Memorandum also stressed capital market development as the main impact of pension privatization:

‘[T]he introduction of the FF pillar will contribute to deepen capital markets. Stock market capitalization in Poland could more than double if the pension funds were to invest their proceeds in the stock market over the next ten years. Pension funds could play a very important role in the financing of housing, infrastructure and environmental needs through, for example, the purchase of mortgage and/or municipal bonds.’ (World Bank 1997:75)

## 5 COMPARATIVE ANALYSIS

### 5.1 PENSION REFORM, ECONOMIC DEVELOPMENT AND THE TRANSITION

When analysing possible links between pension privatization and economic development in CEE, the reader should be reminded that contrary to the Latin American precedents, Hungary and Poland were certainly no developing countries when setting out to reform their pension schemes. However, they were in the midst of a fundamental transformation from a state-led to a market-oriented approach to economic policy.<sup>32</sup> Thus, ‘reducing the size of the state’ (World Bank 1994b:17), particularly in public sector reform, was one of the declared aims of the economic and political transformation process. Hence, political actors committed to this

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<sup>32</sup> For details see, e.g., Lavigne (1995), Havrylyshyn and Nsouli (2001), and Barr (2005).

agenda felt that pension privatization would perfectly match their overall efforts, as the Hungarian example shows:

‘The re-birth of the system of these funds is also motivated by the fact that Hungary has become a member of the Council of Europe and wishes to become, as soon as possible, a member of the European Union. This process may be helped along by reducing the excessive role undertaken by the State’ (Ministry of Finance 1994:5).

Moreover, the CEE countries’ plan to join the EU in the near future implied that they had considerable economic catching-up to do. Calculations based on 1996-98 growth rates showed that those transition countries with faster growth than the European average would still require 26 years (Hungary) or even 36 years (Poland) to close to 75 per cent of future European income levels (Warner 2001:74).<sup>33</sup> Hence, economic development and growth were clearly prominent issues on the political agenda in CEE. International advocates of pension privatization presented the iconoclastic move as advantageous in this specific transitional context:

‘The preeminent economic challenge for the Central European economies ... is to grow rapidly for a sustained period of time in order to narrow the economic gap with Western Europe. ... Pension reform merits a prominent place in the reform agenda in the coming years, as a centerpiece of a high-growth strategy.’ (Sachs and Warner 1996:4,28)

‘Pension reform that reduces spending in the PAYG scheme and introduces a second pillar could allow these [Central European] countries to address the aging problem while accelerating growth, enabling them to converge more quickly to Western European income levels.’ (Palacios and Rocha 1998:213)

Finally, capital and financial markets – non-existent during the socialist period – needed to be built up from scratch, hence the pension reformers’ strong emphasis on the role of pension funds as institutional investors in their immature capital markets. Taking Poland and Chile as examples, the following quote illustrates the differences in starting conditions between some of the Latin American and all of the CEE countries:

‘Poland is in a very different position from Chile, which introduced its funded pension scheme during a period of economic growth, when it had established capital and financial markets, and did not need to do consensus-building for reform. By contrast, Polish policymakers faced a fragile economic recovery and immature capital and financial markets, and reform of the Polish pension system must accommodate diverse interests.’ (World Bank 1994b:34)

It should be noted that thirteen years later, financial markets were still considered ‘relatively undeveloped and incomplete in Eastern Europe and the former Soviet Union, where few

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<sup>33</sup> Hungary and Poland feature among the three best performers in Warner’s calculation, while other transition countries are not catching up at all, or may take as long as 190 or 290 years (Tajikistan and Turkmenistan, respectively).

countries have financial systems that extend beyond banking' (Chawla et al. 2007:118), which is increasingly seen as a constraint to pension privatization.

## 5.2 ECONOMIC ARGUMENTS IN THE PENSION REFORM DISCOURSE

As pointed out in Chapter 1, the World Bank's prominent pension reform strategy was not only driven by social policy considerations but also by macroeconomic promises, such as the increase of long-term saving, capital market deepening, and economic growth. Moreover, the Bank discussed possible implications of pension privatization for labour markets and fiscal policy (World Bank 1994a). As illustrated by Chapters 3.2 and 4.2, economic arguments also played a major role in the Hungarian and Polish pension reform discourse. Those can be summarized as follows:

In *Hungary*, it was expected that pension funds would encourage saving, expand the sources available for long-term investment, and thus promote the development of the Hungarian capital market (Ministry of Finance 1994). Mandatory pre-funding was also thought to spur investment and contribute to economic growth (World Bank 1995). Additionally, distortions in the labour market and, consequently, the size of the informal economy could be reduced. Finally, public finances were eventually to be balanced by the radical move (Ministry of Welfare and Ministry of Finance 1996; Rocha 1996).

In *Poland*, the advocates of mandatory pre-funding expected that pension funds play an important role by channelling savings into productive investment, and assist the development of capital markets (Lewicka et al. 1996). The new system would create the conditions for a lasting and balanced economic growth (Pełnomocnik Rządu 1997). Additionally, a mandatory second tier would improve the financial and economic literacy of the population, strengthen individual responsibility, and improve consumer choice. The multipillar system was also thought to accelerate the privatization of state-owned enterprises (Topiński and Wiśniewski 1991; World Bank 1993). Finally, pension privatization would help control public spending, reduce inflationary pressures and increase public resources available for poverty relief (World Bank 1994b).

The economic arguments presented by pension reformers in Hungary and Poland are not identical, reflecting some of the specific needs of the local reform agenda. Moreover, in Poland there is more scepticism about the causal link between pension privatization and economic growth. Yet, in both Hungary and Poland there are reformers who firmly believe in the growth-enhancing impact of the radical move.

Overall, the obvious similarities in the patterns of reasoning in Hungary and Poland are striking. Moreover, there are many parallels between the discourses of pension reformers in both countries and the discourse of the ‘new pension orthodoxy’, exemplified here by the World Bank. Those parallels are not a coincidence but the result of a common international transmission mechanism of ideas (Müller 2003). Clearly, the ascendancy of the new pension reform paradigm was related to the emergence of a relevant epistemic community: a network of professionals with a common policy enterprise, sharing faith in a set of normative and causal beliefs, having similar patterns of reasoning and using shared discursive practices<sup>34</sup> – such as the ones documented in this paper. As part of this networking, World Bank officials directly assisted the making of pension privatization in Hungary and Poland, which gave them extra leverage in terms of the shaping of the pension reform discourse.

Chapters 3.2 and 4.2 have also shown that from the mid-1990s onwards, the reform discourse in Hungary and Poland started reflecting the international pension reform controversy (see e.g. Müller 1999). This was only shortly after the World Bank had started its involvement in the Hungarian and Polish pension reform arena, provoking strong criticism from the defenders of the Beveridgean and Bismarckian traditions in both countries.

### 5.3 ECONOMIC ISSUES IN THE POLITICAL ECONOMY OF REFORM

Earlier political economy analyses of pension reforms showed that macroeconomic promises, however disputed, were clearly a major driving force of the fundamental paradigm shift. As noted in Chapter 1, those analyses were mostly applied to ‘second-generation’ pension reforms in Latin America (Madrid 2003; Weyland 2004). But in how far was the making of pension privatization in the transition countries of CEE related with macroeconomic issues? In order to answer this question for the cases of Hungary and Poland, the main political actors and the reform context will be identified, with a view to the relevance of economic considerations and constraints in both pension reform arenas. Although individual actors were certainly not irrelevant in the two country cases, the following analysis will focus on corporate actors within and outside government.

Chapters 3.1 and 4.1 have shown that interestingly, the government portfolios formally responsible for the existing pension schemes – the Ministry of Welfare in Hungary and the Ministry of Labour in Poland – were not the only intra-government actors shaping pension reform. Rather, there was yet another important portfolio elaborating pension reform

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<sup>34</sup> For more details on epistemic communities and policy reform see Adler and Haas (1992) and Haas (1992).

blueprints and pressing for their implementation – the Ministry of Finance. In both Hungary and Poland, the Finance Ministry turned into the most important actor in the local pension reform arena. For this actor, staffed with neoliberally trained economists, pension privatization was a means to achieve macroeconomic objectives featuring prominently on the ministerial agenda, such as the development of capital markets, economic growth and balanced fiscal accounts.

Contrary to this, the Welfare Ministry (Hungary) and the Labour Ministry (Poland) were less than enthusiastic about structural pension reform, thus reflecting the existing Beveridgean and Bismarckian traditions in CEE. These Ministries stressed that a pension system should not be designed to bring about macroeconomic desiderata, but to serve the aged. A thorough reform of the existing public PAYG scheme was deemed to be sufficient, while a radical regime change in old-age security was seen as neither desirable nor necessary. Yet, in neither of the two country cases could the Labour or Welfare Ministries prevent the radical move, although the Hungarian Welfare Ministry managed to lower the share of contributions to be privatized in an inter-ministerial compromise. In Poland, a Minister of Labour reluctant to engage in structural pension reform was simply replaced with a new Labour Minister with a prior commitment to mandatory pre-funding.

In its endeavour to bring about pension privatization, the Finance Ministry was supported by local interest groups, such as business organizations and the financial sector, and the IFIs – the natural constituency of a mandatory IPF tier. Contrary to this, trade unions, social security employees and pensioners' associations initially opposed pension privatization, alongside the Labour or Welfare Ministry. It should be noted that eventually, however, unions agreed with their governments' reform plans. In Poland, the Solidarity trade union even supported a partial shift to funding before the Labour Ministry did.

Interestingly, left-wing parties did not necessarily join the ranks of reform opponents either. It should be noted that market-friendly reforms have not always been carried out by neoliberal governments, but also by 'unlikely' left-wing or populist administrations (Cukierman and Tommasi 1998a, b).<sup>35</sup> The postsocialist governments in Poland and Hungary joined the ranks of 'unlikely' administrations involved in pension privatization. It can be argued that left-wing administrations are under stronger pressure from international creditors to demonstrate their commitment to market-oriented reforms. Moreover, they are often better suited to handle

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<sup>35</sup> When such unlikely administrations are involved in policy reform, this amounts to a 'Nixon-in-China syndrome' reversed. On this syndrome see also Ross (2000).

opposition from trade unions. In Hungary and Poland, the governing parties had traditional ties with the unions and used them to ease resistance. On the other side of the coin, these ties implied that pension reformers were forced to negotiate with reform opponents and to make concessions.

Scholars of the political economy of policy reform have argued that radical change may be induced by a preceding crisis. Situations of perceived emergency may persuade opposing groups to agree upon unpopular measures. Crises can break stalemates and facilitate the demolition of political coalitions that had previously blocked reform (Drazen and Grilli 1993). The so-called ‘benefit of crises’ hypothesis is thought to be relevant here, as Chapters 3.1 and 4.1 have shown that Hungarian and Polish pension reformers clearly reacted to an atmosphere of crisis. Observable emergencies included a crisis of the pension system proper, fiscal imbalances, an economic crisis, and high external debt.

A rising deficit in the public pension scheme may be a straightforward motive for reform. Also, public pension expenditure may be considered too high in a context of general fiscal imbalances. Both scenarios can be observed in the pre-reform setting in Hungary and Poland. Moreover, both Hungary and Poland opted for pension privatization in a context of high external indebtedness. In addition, Hungary witnessed a grave economic crisis shortly before embarking on pension privatization. All but the first of these crisis scenarios – a crisis of the pension system, high budget deficits, an economic crisis cum external debt, or severe external indebtedness alone – are effectively macroeconomic emergencies and constraints with an impact on social policy making, as will be explained in the following.

Fiscal crises turn the Ministry of Finance into a potential actor in the pension reform arena. More specifically, when pension finances display a deficit, the resulting dependence on budgetary subsidies grants this likely advocate of the ‘new pension orthodoxy’ an important stake in old-age security reform. In both the Hungarian and the Polish case, the Finance Ministry gained extra leverage in pension reform due to fiscal emergencies, which in Hungary was reinforced by the context of severe economic crisis.

When external debt is high and economic crisis looms, governments often tend to stress their general commitment to market-oriented reform. The announcement of pension privatization can be interpreted as a ‘signalling’ strategy (Rodrik 1998), as rating agencies include radical pension reform as a point in favour in their country-risk assessments. Critical indebtedness also makes it more likely that the IFIs get involved in the local pension reform arena (Brooks 1998, 2001). The World Bank, with its prominent stance in pension reform, amounts to a

powerful external actor, exerting its influence first and foremost as an agenda shifter in the local debate, engaging in an expert-based knowledge transfer. Moreover, lending activities and conditionalities were key instruments to support pension privatization in CEE (Holzmann 2000). Whereas in Hungary, the World Bank's important involvement was deliberately kept low-key to avoid the perception of a pension reform dictated by the IFIs, the Polish pension reform team was openly headed by a World Bank economist on leave, granting the Bank extra leverage.

Hence, the 'benefit of crises' hypothesis can be applied to the Hungarian and Polish cases of pension privatization. The observable emergencies – a crisis of the pension system proper, fiscal imbalances, an economic crisis, and high external debt – resulted in a significant change of actor constellation in the pension reform arena that enabled a shift to mandatory pre-funding. All but the first of these four crisis scenarios are effectively macroeconomic emergencies and constraints with an impact on the political economy of pension reform.

## 6 CONCLUSION

The past three decades have seen a massive wave of pension privatizations, mainly in Latin America and Eastern Europe. This iconoclastic move went along with high hopes in terms of a positive impact of mandatory pre-funding on economic development. Those promises and expectations have been heavily contested on theoretical, empirical and normative grounds. Nevertheless, they amounted to a major driving force in the political economy of pension privatization. In this context, it is particularly intriguing to look at the interaction between pension privatization and economic development in CEE, a region that – contrary to Latin America – does not form part of the developing world.

This in-depth analysis focused on the cases of Hungary and Poland. In 1998 and 1999, respectively, those were the first EU8+2 countries to embark on pension privatization, a move which amounted to a deliberate break both with their own social security traditions and with the pension policy of peer nations, creating an influential precedent in the region. In the following, the findings from the comparative analysis of the Hungarian and Polish cases are summarized.

*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.

*Economic arguments in the pension reform discourse:* In Hungarian and Polish pension reform, macroeconomic promises – mainly the increase of long-term saving, capital market deepening, and economic growth – featured prominently. 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 prominent World Bank discourse. The use of similar patterns of reasoning and the sharing of discursive practices point to a well-established epistemic community with a global radius of action.

*Economic issues in the political economy of reform:* In the making of pension privatization, 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 clearly enhanced 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.

To sum up, this paper has shown that economic factors and motives have played a prominent role in CEE pension reform. Only time will tell, however, whether some of the macroeconomic promises that greatly facilitated the paradigm shift in CEE old-age security will come true. If not, it can only be hoped that mandatory pre-funding at least does not harm future pensioners.



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