Prof. Igor Tomes, PhD

Social security reforms in central Europe

Opening remarks: when discussing reforms one cannot focus only on one social security branch. Changes in unemployment benefits had impact on sickness insurance; changes in pensions had an impact of disability benefits and on social assistance and social safety nets; etc. The lesson to be learned is that any social reform effort has to address the whole social protection system should it be fully successful and sustainable.

The social reform process is not only a macroeconomic exercise. It is essentially also a political and social exercise, because of traditionalism, heritage, political environment and rule of law. Social acceptability can become a bottleneck for the reform. In a democratic country any social reform must respect incontestable human rights guaranteed by constitutions as well as acquired rights as well as rights in the process of acquisition. This important aspect is often underestimated by our macroeconomists. This makes social reforms extremely sensitive to public acceptance.

1. The need for social reform of social security

There is evidently a need for social reform in central and east European countries, including the Czech Republic. The reasons are (i) the social and economic heritage, (ii) the demographic changes, (iii) financial sustainability of social protection and (iv) social consequences of economic development especially in the transition from a command economy to a market economy, form “socialism” to “capitalism”.

1.1. Heritage

The preceding regime was based on command economy and central planning and was well accommodated to its needs. However, they are not suitable for a democratic society and a market economy. The main defaults included lack of equity and equality. There was no equity or equality in eligibility and benefit design. Preferential treatment of certain cohorts led to evident discrimination.

Most of the benefits (pensions) were paid out of the state budget as part of the over-all distributive system run by the central state controlled economy. There was no need for any arrangement of the social insurance type with pensions earned through regular contributions. The only contributions to social security paid in most countries were those paid by the employing state-owned establishment to sickness insurance operated by trade unions. This was mere accounting transaction and not a financial participation of the people in the cost of the system. This also applied to the Czech Republic.

Pension rights were merit-related. The merits were earned either by special loyalty to the regime (mostly for “merited” members of the communist party) or by participation in arduous and hazardous employments (the so-called “categories of ´work”). There was also gender discrimination.

Social security had an improper philosophy. Under a command economy with total state ownership, people were fully dependent on incomes from the state budget be it wages or pensions and other benefits. This led to the attitude that the state has to take care of all social problems. With the transition to a market economy, people had to learn to “take care of themselves” and financially participate in all social costs. Contributions and income taxes, with employer participation, were introduced. But this in turn increased the social cost of labour and "handicapped" the new class of entrepreneurs.

The systems had a design improper for a market economy. Pensions were not regularly indexed. Social security lacked some essential benefits to provide in cases of unemployment and poverty. New benefits had to be developed to cope with unemployment and inflation, the social consequences of the transition.

1.2. Financial sustainability

The inherited social systems were generous. The pension systems were the most expensive; they provided too many people with pensions. Although affording small mounts the total cost was great. Too many people received too little at a too high a cost. This was accelerated by early retirements, soft disability definitions and generous survivors pensions. The systems became unsustainable to public finances. The cost to the state budget was rapidly increasing and reached incredible size. In the Czech Republic the pension insurance costs grew from 7,5% of GDP in 1995 to 9,2% in 2002.

Similarly the cost of sickness insurance grew from 1,3% of GDP in 1995 to 1,4% in 2002. This was due to improper governance as well as to a growing abuse of the system mainly by employers in economic difficulty, convincing their employees to "go sick" to gain savings on wages as well as by unemployed who prefer sickness benefits to smaller unemployment benefit. The fact that the total cost did not grow quicker is due to the fact that maximum benefit in monetary terms was kept low.

Also health insurance grew from 6% of GDP in 1995 to 6,8% in 2002, but this is mainly covered by employer-employee contributions and the state budget participation represent only a 0,7% of GDP, although also rapidly growing (practically doubled compared to 0,4% in 1998, when the social democratic government took over).

The cost of the social safety net (including family support) is constantly at a level of 2,5% of GDP.

1.3. Demographic changes

The Czech Republic in principle shares the same pattern of demographic changes as elsewhere in Europe. The processes are, however, unexpectedly more drastic. The most recent forecast is that population aged over 65 will represent some one fifth to one fourth of the population. Age expectancy of those aged 65+ increased in the last 7 years by nearly 1,5 years (men 79,9 years and women 82,2 years). At the same time natality dropped quicker than mortality, thus the total population reduced from 10,33 mil in 1995 to 10,2 mil. in 2002 (approx. 150 thousand people less), in spite of migration from Slovakia and other neighbouring post-soviet and post Yugoslav countries.

1.4. Economic development

The economy is recovering from a recession and GDP growth is estimated at some 2,8%. Inflation dropped from some 9% in 1995 to less that 2% in 2003. Unemployment grew from some 3% in 1995 to over 10% at the end of 2003. With the new VAT tax increase in services it is expected that some 300 thousand self-employed persons will have to close down, thus increasing the cohort of unemployed persons. The process of restructuring is still underway. The good news is that foreign investors requiring cheap highly qualified labour are moving in at larger numbers and Czech entrepreneurs are increasing successful on foreign markets – both within and outside EU. Joining the EU is expected to be beneficiary to economic growth.

* * *

To sum-up there is n evidence that there is an undisputable need for reform of the whole social sector, because the economy and public finances are incapable of supporting the growing costs. There is need to increase support to families and limit the generosity towards the seniors and handicapped. There is a need to reduce dependency on public finances and increase the responsibility of people for their future needs.

2. Reforms and transition

2.1. Pension reform is an ongoing process

The social reform is an ongoing process. If we look back on the 150 years of social insurance development we will find a reform effort every 10-20 years. This is essential to keep the system sustainable in the constantly developing and changing economic, political and social circumstances of social life. This is inevitable because of the aging of all the social insurance systems (increasing liabilities as the system matures).

In central and east European countries the social systems reforms started in the early days after the take-over from the communist regime in 1989. Unemployment benefits and regular indexation to price increase were introduced, preferences were removed, etc. to meet the newly emerging social needs. Contributions to social insurance were introduced.

In each stage of the transition some reform had to be undertaken to meet the changing need. It thus cannot be claimed that nothing happened and that the reforms now underway in some of the countries are initiating and launching social reform activities. They are introducing new approaches in an on-going process of social reform in the transition to meet changing needs. Even the idea of funding is not new; provident funds introduced by the United Kingdom in its colonies in the late 19th and early 20th century were funded and reformed into pension schemes in the 1960ties. The early Bismarckian social insurance schemes were funded and were reformed into pay-as-you-go budgeted systems after the 2nd world war; because of the hyperinflation they were unable to meet their liabilities.

The new idea is privatisation of public endeavour - the introduction of private governance of mandatory social insurance and saving schemes.

In the Czech republic reform targets in 1990 were to remove discrimination and introduce regular indexing of pensions and a guarantee of a decent minimum living to meet the social consequences of liberalization of prices and consequently inflation. The government prepared and Parliament agreed to a Scenario of Social Reform (1990), which was designed to meet the social consequences of liberalization (launched 1.1.1991) and privatisation (first stage – small privatisation and restitution were launched in1992) as well as increase the responsibility of citizens (contributions to health and social insurance were introduced as from 1.1.1993) for their well being in times of future need and welfare of their family. New benefits were introduced, discrimination removed (work categories abolished), employment offices created and social insurance contributions introduced. Health insurance was introduced.

The process was interrupted by the separation of the Czech and Slovak Republics in 1992/1993. Social reform was overshadowed by fiscal, monetary, administrative and property problems; all had to be honestly divided and reshaped to meet the new economic, political and social environment.

The Czech Republics resumed its social reform efforts only in 1994. While the Civic Forum government was inspired by euphoria of victory over communism, the new government elected in 1992 was a centre-right government and thus launched an austerity program in the social sector. The first step led to the introduction of voluntary pension funds (1994), reform of pensions (1995) and family benefits (1995). However the scandals removed the government (1996) and stopped the social reform profess; thus sickness, social welfare services (including social safety net benefits) were not reformed.

After an interim professional government social democrat government was elected (1998) and re-elected (2002), which has introduced some very minor adaptations to the social systems and in now under pressure of the opposition preparing a pension reform. Being aware that no substantial pension reform can be fully successful unless based on an all-national consensus, the government is now seeking such a consensus.

2.1. Difficulties of pension systems in the transition period

All actors on the political scene realise that high and constantly growing unemployment and accelerated aging of the population all for further pension reforms inevitable. Social costs are becoming unsustainable to the public finances. Their growth is not only a pest to the growing economy (high social costs) but also endangers our possibility to enter the Euro zone.

Evidently the demographic dependency ratio is growing and will probably grow more substantially in the coming years. The forecast is 25% in 2040. In these conditions the economically active population will not be able to support the present pensions both in numbers and amounts. Increase of the demographic dependency ration is alarming.

Indicator (´000)	1995	1996	1997	1998	1999	2000	2001	2002
Total population	10 331	10 315	10 304	10 295	10 283	10 272	10 224	10 201
Age: 0 - 14	1 921	1 867	1 818	1 773	1 729	1 685	1 643	1 605
15 - 64	7 044	7 066	7 089	7 114	7 138	7 165	7 168	7 180
65 +	1 366	1 382	1 397	1 408	1 416	1 422	1 413	1 416
Dependency ratio	19,39	19,56	19,71	19,79	19,84	19,85	19,71	19,72

The number of people who live over a hundred years have increased from 232 in 2000 to 277 in 2004; they draw a pension for at least 40 years at the present level of pensionable ages.

Life expectancy	1995	1996	1997	1998	1999	2000	2001	2002
Age 60 +: men	15,94	16,25	16,39	16,72	16,85	17,02	17,32	17,28
women	20,23	20,39	20,67	21,00	20,99	21,21	21,23	21,31
Age 65 +: men	12,67	13,09	13,19	13,42	16,60	13,72	13,95	13,93
women	16,20	16,36	16,63	16,92	16,91	17,09	19,09	17,16

There was a drop in replacement rates over the last 15 years. The average replacement rate in less than 50 per cent and is moving towards 40 per cent. limit provided by ILO Convention 102/1952 on minimum standards of social security.

Nevertheless the growing costs of the system are rapidly growing and becoming unsustainable to public financing.

Expenditure (in % GDP)	1995	1996	1997	1998	1999	2000	2001	2002
Pension insurance	7,5	7,8	8,8	8,8	9,1	9,2	9,0	9,2
Total social cost	16,9	17,3	18,2	18,8	20	20,1	19,7	20,3

There are evident deficiencies in collecting contributions mainly due to evation of small employers and self-employed persons from the tax system. The “grey” economy is an important factor in the economy of the transition countries and was constantly growing over the last years.

There are evident administrative lags in processing pensions in most of the transition countries due to slow computerization and digitalisation of administration procedures and registers.

There is thus a general feeling that something has to be done. However, there is little agreement on what.

3. Options for a pension reform

The need for reform is evident, but countries may face strategic choices about how best to achieve reform.

3.1. Parametrical reform options

The politicians prefer parametrical reforms. They have experienced those in past 15 years and were successful.

The parametrical reforms approached most often the issues of pensionable age, qualifying period, conditionality for eligibility to pension and relation between benefits and contributions.

Increase of pensionable age is a difficult issue and in many countries political parties gained support of the constituency with promises not to increase pensionable age. It is a politically painful matter. However, the number of persons eligible to a pension could no longer increase no matter how the moratorium was achieved. If a country wants to continue in this process an acceptable systems dependency ratio should be established and the parametrical reform should aim at maintaining the balance. Under present conditions the pensionable age should reach as soon as possible a uniform age of 65, with no possibility for early retirement other than by accruing a disability pension. Early retirement represent some 15 to 20% of newly granted pensions. Abolishment of lower pensioable age for women is another source of essential savings in the scheme.

In most transition countries the qualifying period for eligibility to an old-age pension was prolonged however insufficiently. In view of the aging of the population and prolongation of life expectancy the qualifying period should be increased to at least 40 years, if the old-age pension is to be drawn for an average of 20 years.

Some of the transition countries tightened eligibility conditions, but insufficiently. Disability should be redefined. Eligibility to a widow and widower pension should be limited to those who care for dependent children up to age 18, and persons meeting conditions for a disability or old-age pension.

Some of the countries like the Czech Republic reformed the system by replacing period of employment by periods of insurance and changing the assessment basis by tightening the dependency of pensions on paid contributions. This made pensions depend on contributions and motivated insured persons to pay pensions, thus improving the collection rate.

However, the parametrical reforms in the last 15 years did not curtail sufficiently the number of eligible persons. They slowed down the growth of the deficit, but did not stop the growing public debt. That is why more radical systematic reform are sought and have been developed in some of the transition countries. Their motivation is simple – they have to reform public finances if they want to meet the EURO criteria and pension debt is among the eminent spenders.

3.2. Non-parametrical reform options

There are in principle two major options:

a) To move from defined-benefit (DB) to defined-contribution (DC) pensions. One alternative, but not the only one, is to introduce the Swedish Notional Defined Contribution (NDC). The advantage and disadvantage is the pay-as-you-go financing, which is less sensitive to economic development but still sensitive to demographic aging, though less than the present approaches.

b) To diversify financing of old-age pensions by introducing mandatory funded „second“ pillar, an approach developed in Estonia, Hungary, Latvia, and Poland, and recently also by Bulgaria.

In the Czech Republic there is a general agreement that pensions have to reformed, but disagreement on how. While to coalition government prefers to have the NDC, but combined only with voluntary pension funds, the right-wing opposition (ODS)[1] is for a three-pillar pension system. Left (communist) opposition calls for parametrical reform only.

4. Constraints to reform

There is not only a need for a social reform, supported by economic and political driving forces such as the growing private sector and competitors in a globalizing economy, but there are also (i) economic, (ii) political, (iii) institutional and (iv) administrative constraints to social reforms in post-communist countries. That makes the problem more complex and politically sensitive.

Economic constraint include mainly cost of implementation and in the case of systematic (non-parametrical) reform also transitional cost. All reforms when implemented require restructuring of the establishment. Mere restructuring of the information system needed to implement any sizable reform is costly and needs to be accounted for in the reform project. All reforms need to finance the transitional period to the post-reform arrangements; a transition always has an impact on rights in the course of acquisition. In the case of a systematic (non-parametrical) reform transitional costs represent important sums for public financing to cover, if a

[1] Obcanska Democraticka strana.

funded pillar is included in the reform scenario. This one of the major concerns when s “second” (funded) pillar is considered and eventually refused.

Lack of a nation-wide consensus is the major political constraint. In the Czech Republic the issue of the pension reform was a major issue in the elections. Political parties gained votes on pension promises. So long as the pension reform is an electoral issue, no real progress can be achieved. The reason is simple – elections are every 4 years and the pension reform is a mid to long-term issue. It has to be treated professionally and takes years to design it properly. It should not become an issue of political gambling.

The most evident constraint is the institutional constraints. In some of the reform countries there was an evident lack of institutional capacity to implement the reform. All reforms need timely restructuring of the implementing institutions either by allowing a *legis vacancies*, i.e. period for preparation of the implementation (e.g. in 1924 the insurance reform legislation in the Czech Republic came into effect only 2 years after it was adopted), or the implementation capacities should be developed at the same time as and together with the development of the reform provisions.

Administrative constraint is generally in the lack of professional staff to implement the new system and master the new procedures. One cannot change the people and therefore needs to train those that are available. Most of the reform designers forget the training element and lack of knowledge and experience evokes many problems of implementation that can easily be avoided.

To sum up, a pension reform design must treat problems of public relations and information, institutional building and training issues simultaneously together with the drafting of the legislation.

5. EU social model and the pension reform

Whatever option is selected the major objectives in a European democratic country, within the frame of EU, should be the same. These objectives were formulated in the EU Council conclusions (2003/C 260/02) on open coordination for adequate and sustainable pensions:

a) the systems should be financially sustainable, yet respecting social human rights;
b) the reforms should aim to increase pensionable age by 5 years by 2010;
c) enable people to remain in the labour market and work longer;
d) ensure the political acceptability of the pension reform;
e) ensure the transportability (transferability) of occupational pension rights;
f) future adequacy of pensions.

In short the pension reforms should lead to pension systems that will be

a) sustainable,
b) provide adequate pensions, support competitiveness
c) assist employment of the elderly and
d) approach social protection in a complex manner.

At the *acquis communautaire* discussions social protection in accession countries was reviewed from the standpoint of EU legislation and compatibility with best practices in EU member states. The accession countries have, however, differed from the best practices and developed their own new best practices.

There are more legitimate reasons for doing so. As already mentioned earlier there were the heritage and the transition to a market economy. These unique (never before experienced transition from socialism back to capitalism) and difficult (catastrophic drop in GDP, hyper inflation triggered by price and wage liberalization, and unemployment also due to privatisation) processes had to be developed in difficult economic and social conditions with heavy constraints on public finances and low GDP per capita (compared to EU member states). It was impossible to follow the approaches of stable and richer EU member states.

As all pension systems in EU member states need change to become sustainable there is a legitimate question as to whether the "new members" are not an experimental playground for "old members" to follow in the near future. In my opinion pension reforms in accession countries seem to introduce new approaches of which EU social model must take account.

6. Final remarks

The lessons to be learned from the reforms already implemented by now include

a) The reform must be complex and well harmonized with public finance (tax) reform. No piecemeal approach was as yet fully successful.

b) The reform must be open to the public. It needs professional design, transparency to the politicians and the general public. No one at any time should be taken by surprise.

c) Implementation planning and staff training should go hand in hand with design development.