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# **The Political Economy of Labour and Social Reforms - Poland**

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## **1. Introduction**

In 2009 Poland celebrates – together with many other European countries – the 20<sup>th</sup> anniversary of the democratic breakdown (“Solidarity” based government in Poland, fall of the Berlin wall). Democracy opened the door to economic transition from the centrally planned economy to market based economy. In some countries, such as Poland the starting date of the economic transition is well defined, in some other countries entering transition was less sharp but in principle the entire Central European part of the former Soviet bloc started the transition in early 1990s. Russia and Ukraine followed a couple of years later.

Transition in Central and Eastern Europe (CEE) had various paths in countries of the region. That apply to radicalism (shock therapy in Poland versus soft approach in the Czech Republic), as well as time path and scale of both positive and negative outcomes.

It is much easier to point out starting dates of transition in CEE countries than to do that with respect to completion of the process. In this study I assume the transition in Poland ended around 1998 and smoothly turned into pre-accession process that led to European Union membership that started in 2004. Although the two processes do not have any sharp turning date, they overlap to an extent, they should not be confused with each other. The latter one would have been necessary to pass even if Polish economy had never been a planned economy. The same applies to other CEE countries that became members of the EU. Since 2004 I assume Polish economy develops along more or less typical European path.



however, projections clearly show the share needed for financing transfers will keep increasing, which leads to undesired consequences, including social ones.

Population ageing is in Poland still less advanced in comparison to most West European countries. According to demographic projections in the decades to come stronger pace of ageing is expected in Poland. However, expenditure related to social expenditure became high in Poland even in times of still pretty good demography, namely in the 1990s. The reason for that was easy available early retirement schemes. Their scale was so large that average actual retirement age at the beginning of the 2000s reached 55 for women and 59 for men. That was mostly the lagged effect of the martial law of the 1981. The vast majority of schemes originated in the period just after 1981. Granting that privileges was a kind of costless (that time) way to reduce social pressure on political situation. – After two decades Poland became the European leader (together with Italy) in expenditure on pensions in terms of GDP. Another reason for that was relatively high replacement rates not only for workers retiring after reaching the statutory age (60 for women and 65 for men) but also for those retiring early. Both the possibility to and the incentive to retire early led to large outflow from the labour market. In mid 2000s the employment rate in Poland fell to 51.2 percent (that time the lowest level in the EU). Now the rate is 59.2 percent – still one of the lowest in the EU. That low level of the overall employment rate results from the extremely low rate among those in the 55-64 age bracket (39.2 percent) [Eurostat].

The scale of early retirement was probably the most distinguishing feature of the Polish labour market. It was since the schemes were abolished in 2008. However, effects of their availability in the past will last for around 5 years (roughly the numbers of years retirement was postponed for). This study analyses labour market and social consequences of early retirement in Poland such as: the highest in the EU tax wedge (net of transfers received) phased by a family of two adults with average income and two children (42.2 percent in 2006) [OECD] and risk of poverty for prime age workers much higher than for pensioners (21 and 7 percent respectively in 2006) [Eurostat]. A new pension system replaced the old one in 1999. The new one reintroduces intergenerational equilibrium and fairness. The key goal of the pension reform was a reduction of burden imposed on workers because of the need to finance increasing transfers. Projections by the EC suggest that goal will be reached.

Proportions current GDP is divided between remuneration of economic activity and financing transfers change slowly. In the short-run another effect should be analysed, namely a substantial reduction of unemployment. Throughout the 1990s and the first half of the 2000s Poland had very high level of unemployment (the highest rate of unemployment in the EU for almost entire that period). Now that rate is below EU average (7.0 percent in Dec. 2008 and 7.7 in March 2009). The study presents, among others disputes on issues such as minimum wage, working time, fix term employment, job protection, and so on.

Institutions do not work efficiently in Poland. That is reflected in studies such as Doing business (2008) where Poland is classified on 74 position among 178 countries. In many cases people hide their activity in shadow economy not only to save on taxes but also to avoid administrative burden.

The situation in the labour market in Poland in the second half of 2000s has been affected by large scale emigration and vice versa emigration was largely caused by labour market situation. That is another focus of the study presented.

Poland's economy proofed to be more resistant than many other EU economies to the global crisis. That can be analysed from the viewpoint of reasons for that as well as consequences of that on disputes and decisions on labour market reforms in Poland.

## **2. The general picture of various interests**

Political economy approach analyses various conflicts of interest in society. This study presents a general picture of social and political conflicts that create outcomes affecting labour market. The study focuses particularly on the labour market situation in Poland from the point of view of the conflict of interest of economically active part of population and those living on transfers. The latter is narrowed here to the retirees only or mainly.

People can and wish to express their views on issues related to economics. That views are based on both beliefs and interests. The two are psychologically interrelated. Both can be additionally biased if not supported by at least basic economic knowledge. The latter problem particularly applies to pension systems. Individual non-expert knowledge is based

on individual experience that is: (1) short-run perspective – a couple of years is perceived as a long period; (2) limited scale – relatively small group of people involved. There is a number of other issues that may create confusion.

## 2.1. Time horizon

The pension system analysed from the point of view of income allocation over life-cycle needs to be analysed in long term, which implies going beyond the business cycle, and taking into account non-linear relationships among crucial factors, which can hardly be approximated by linear trends that are intuitively applied by individuals. Here I do not mean any formal models but individual “common sense” thinking. In typical situations individuals apply their common sense to the scale of difference between linear approximation and real outcome of non-linear relationships can be neglected, while in the horizon of pension system income allocation the difference can be really substantial. In shorter run, that particularly applies to business cycle fluctuations. Period of recession as well as periods of cyclical growth – if extrapolated – create fear or euphoria respectively.

Politicians adjust to short-run thinking of societies they live in. They are even eager to do that since political active life is short. Next elections matter. In the case of politicians that is rational (with exceptions for great statesmen). However, in the case of the people that is a misconception of their interests. People participate in pension systems for many decades, while politicians “live” many times shorter. That creates time inconsistency.

## 2.2. Universal (nationwide) coverage<sup>1</sup>

Pension programmes that cover a limited number of participants (the number of participants is many times smaller than the entire population) are easy for individual non-expert understanding. However, pension systems that cover entire population are not since there is no external source of improving internal situation. A pension programme can generate rates

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<sup>1</sup> I use the term “universal” for pension systems that: (1) cover entire society or its vast majority and (2) apply the same rules for all participants or with few exceptions.

of return even substantially above the GDP growth since it is based on a sub-sample of the entire economy, while a pension system covering the entire population cannot constantly generate the rates different from the GDP growth rate. [An average in a sub-sample can differ from the average in the general set.] That implies performance of universal pension systems to a large extent is independent from the nature and efficiency of technicalities of their institutional structure.

### 2.3. The state = “St. Claus”

Universal pension system performance is independent from political decisions. At the same time traditional pension systems are designed in a way that hides that, which let politicians to play a game with the electorate. People do believe that politicians can cause an increase of pension system generosity (benefit level, retirement age, and so on). Actually, politicians can really do that but that holds only for some time and create very high cost for societies. The trap is in the fact that the costs are to be covered in the future. In the long run economies – which includes universal pension systems – come back to long-term path closely linked to the long term path of GDP. However, debts stay and need to be paid back.

Thinking of future it is not easy to distinguish promises and real ability of pension systems to pay benefits promised. In the case of the increasing dependency ratio there are only two choices, namely either the economically active receive less net remuneration or the retired receive less benefits. Increasing the retirement age is a combination of the two. Being a good idea it does not change the nature of the choice. Throughout a couple of previous decades politicians have been choosing the first option, namely lowering net remuneration. That has led to high tax wedge levels. It is probably impossible to increase the levels even more. This means the choice has reduced to just one option, namely reduction of pension benefits. Needless to say implementation of that option is rather impossible.

### 2.4. Pension system generosity

In discussions on pension reforms the level of pension benefits is particularly sensitive. However, does the level of benefits depend on the type of pension system? Yes and no. Yes applies to their absolute level measured in Zlotys or Euro. No applies to pension level measured in relation to wages (the so-called replacement rate, usually presented as percent).

Generosity of pension benefits is typically measured by the replacement ratio (relation of benefits to wages). This ratio significantly varies across countries. That creates a perception that it is subject to political decisions or an outcome of social dialog. This is partially true but in the longer run it is not. The ratio is fully determined by two factors: (1) contribution rate, (2) demographic structure. The former should be understood as the real contribution (the part of production factors remuneration that is spent on financing transfers to the retirees). The latter means the number of pensioners divided by the number of contribution payers. The proportion can be improved if employment ratio is improved. That means both more employed in each cohort as well as postponed retirement.

The above can be illustrated by a simple model of intergenerational exchange. The economically active produce GDP but production factors they supply is only partially remunerated today. A part is spent on purchasing pension rights. The rights can be expressed in various way, which matters but does not affect the economic nature of the exchange with the retirees, who turn their pension rights into a right to participate in division of current GDP they do not contributed to.

The demand side of the market is determined by the number of workers, their productivity and the contribution rate. The number of retirees determines the supply side. This can be presented as a simple model, shown in Equation (1).

$$D = c \bar{w} L^W \tag{1a}$$

$$S = z \bar{w} L^R \tag{1b}$$

where D is demand, S is supply, c is the contribution rate, z is the replacement rate, w (bar) is the average wage,  $L^W$  is the number of workers and  $L^R$  is the number of retirees.



Expressing both demand and supply in terms of wages does not narrow the model to non-funded pension systems, but is rather just measuring demand and supply.

In equilibrium, the replacement rate is given by Equation (2)

$$z = c \frac{1}{d} \quad (2)$$

where  $d$  is the dependency ratio ( $d = L^R/L^W$ ).

Given the demographic structure and the institutional framework (retirement age and so forth), the replacement rate depends on the contribution rate alone and does not depend on the type of pension system or its design. The pension market determines the shares of GDP allocated to each generation.

In the short run, Equation (2) can be disrupted. More specifically, the replacement rate can be kept above the sustainable level through further increases of pension system debt, which will never be repaid. This is a temptation for politicians all over the world (and one to which they often succumb). In the long run, however, owing to the obvious limits for raising the contribution rate, a future reduction of the replacement ratio is inevitable with or without reform. In the short-run the alternative mentioned above, increasing contributions or decreasing benefits can be hidden thanks to:

- ✓ Shifts in other government expenditure, which can be good if spending too much is limited but most commonly is bad since other important goals are underfinanced.
- ✓ Cash accounting within public finance allowing for hiding real consequences of today's decisions, which deteriorates future economic performance as well as ability to finance social goals.

Pension expectations expressed in relative terms can be at the level corresponding (on average) to the outcome of equation 2 or can be kept by political promises above that level. Since the real outcome is given, the latter will lead to economic and social problems. So in long-term there are only two options, being either

- reform, which involves reducing pension expectations (expressed as the replacement rate) *ex ante*; or
- no reform, which will lead to cuts in pensions *ex post*.

Choosing the latter would just be cheating the current generation of workers. It should be made clear that a small working population will never be able to provide a large retired population with relative per capita income at the level comparable to what was possible in the case of a large working population sharing its product with a small, retired population. This situation can be overcome only if the consecutive working generations accept a downward trend in rewards for labour and capital.

## 2.5. Choice of pension design

Traditional pension systems were designed as financial pyramids. They operate well as long as population growth (given the employment rate) was sufficient to generate financing at promised levels. Now, when it is not the case anymore, the best that can be done is aiming at intergenerational equilibrium, which means taking into account interests of each generation being first a working generation and later a retired generation.<sup>2</sup>

There is a number of various approaches to pension reforms. They are all based on an attempt to reach contrary goals, namely sustainability and adequacy of benefits. The goals would not be so contrary if charging the working generation more was still possible. Now this seems impossible any more. The interest of the working generation needs to be also taken into consideration.

As already discussed, the relative level of pensions ( $z$ ) is determined by the structure of the population and the share of remuneration for labour and capital, which is taken from the working generation. Policy measures other than shifting expenditure to pensions from other items cannot change that level. The choice of any particular design of the pension system cannot increase the relative level of pensions. On the other hand, the choice of pension system design can affect the absolute level of pensions. If a pension system contributes to

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<sup>2</sup> Intergenerational equilibrium is a concept broadly discussed in Góra (2003)

stronger GDP growth, then such a system can pay out higher pensions in absolute terms. A pension system that slows down the growth pays lower pensions.

There is no miraculous way to keep paying today's level of benefits in times when population structure is substantially changed. That applies also to such reform options as channelling pension contributions through financial markets (called funding) and/or using individual accounts. Both make a lot of sense but for other reasons.

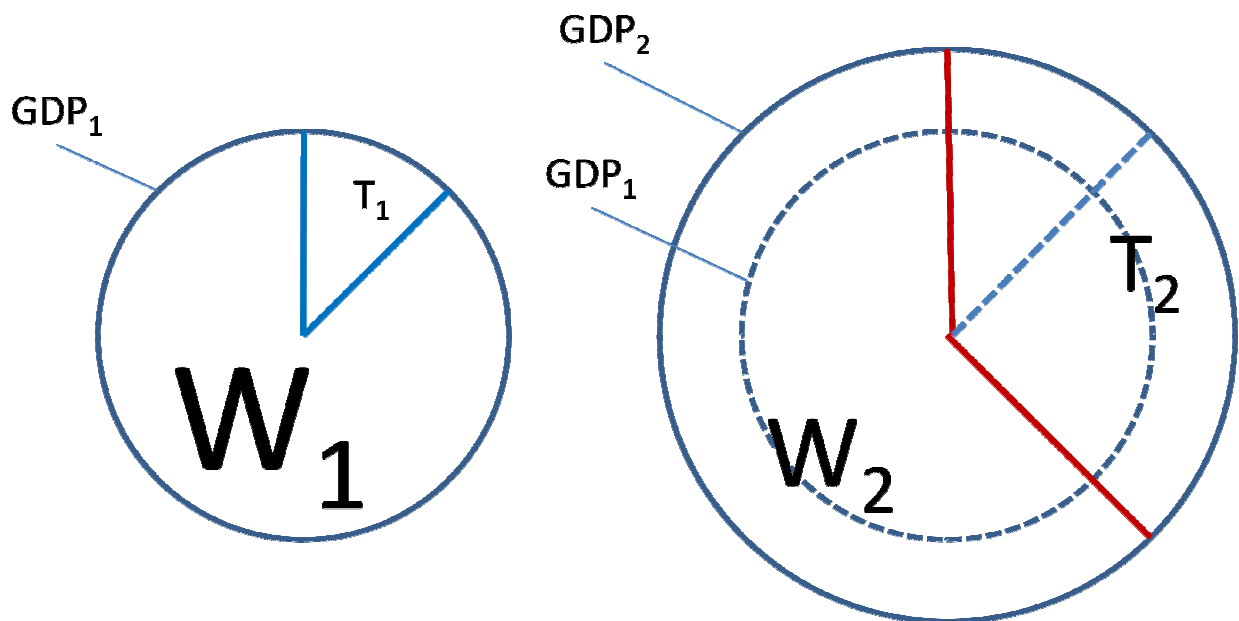
Individual accounts can contribute to higher pensions measured in absolute terms. If a pension system can make pension funds available for investment then it contributes to stronger GDP growth. However, individual accounts neither decrease nor increase the level of pension benefits measured in relative terms since – irrespective to any type of pension system – all pensions in any system it is just a part of GDP produced by the working generation but devoted for pensioners.

However, the key role for individual accounts of any type is to bring pension systems back to neutrality understood as stable burden for each generation imposed by financing the pension system.

## 2.6. GDP division

It should be stressed that due to demographic reasons the cost of pension systems imposed on individual workers now is much larger than it used to be a couple of decades ago when the overall cost was smaller as a part of GDP (smaller share of retirees in population) and the cost was spread over a relatively larger population (larger share) of workers-contributors who paid the cost. Nowadays the cost is larger and spread over a relatively smaller number of workers, hence individual cost imposed on a worker is larger for both that reasons. That change can be illustrated as in Figure 2.

Figure 2. Share of GDP spent on remuneration of production factors versus the share spent on pension transfers



In Figure 2 the circle on the left represents  $GDP_1$  produced by generation 1 a couple of decades ago; the circle on the right represents  $GDP_2$  produced now by the generation 2 (say, children of the workers of the generation 1). Pension transfers are financed out of GDP produced by the working generation, hence remuneration of this generation is reduced ( $W = GDP - C$ ;  $C = T$ ). Generation 1 paid contributions  $C_1$  needed to finance transfers (pensions)  $T_1$  to previous retired generation. Economic activity (work and investment) of that generation was remunerated well  $W_1$  as compared to the value of the product they produced. Current generation (2) of workers being less numerous in comparison to the previous generation (1) has remuneration  $W_2$  strongly reduced, which is inevitable to cover the cost of pensions for generation 1 ( $T_2/W_2 \gg T_1/W_1$ ). This means welfare of the current generation is less important than welfare of the previous one. In the figure  $T_2$  is larger than  $T_1$  for two reasons. First – which is legitimate since this does not reduce welfare of workers – because GDP is larger; second – which reduces workers' welfare – because the share of pension transfer in GDP is growing.

Pension systems need to be reformed throughout Europe since the relative share of pension transfers in GDP is increasing. The goal is to stop that increase, which is just protecting interest of the workers.

Traditional pension systems have ceased to be neutral due to disappearing of the demographic pyramid. Reintroducing this neutrality (intergenerational equilibrium) can be partially achieved through parametric reforms. That is, however, difficult and even if successful it is insufficient unless we go to extreme for instant increasing retirement age much above its current levels.

Benefits measured in absolute terms are not constrained by demography. Their level increases when GDP growth is strong. The benefits can increase in absolute terms even if the replacement rate decreases.

Distinguishing the difference between the two measures of pension benefit level really matters for designing new pension system arrangements. They should aim at neutrality with respect to the factors that pretend they can cause a sustainable increase of benefits in relative terms (for instance overpromising). New arrangements should also aim at stimulating factors that can generate positive externalities on the top of reaching social security goals (for instance effects of channelling pension system flows of money through financial markets).

The replacement will decrease in the future. This seems inevitable. However, it will decrease not because of pension reforms or any other institutional changes but because of the change of demographic structure. That is extremely difficult to explain. Here individual retirement accounts can help. A shift from defined benefit regime to defined contribution regime mean also a shift from politically delivered promises to automatic adjustment.

## 2.7. Public versus private institutions running the pension system

Another perception based problem concerns costs of running the pension system. If they are publicly managed costs can be easily hidden in general taxation but if private institutions are involved in running the system then costs become automatically visible. So even if costs are

exactly the same in both cases it looks as if the solution involving the private sector was more expensive. That additionally fuels etatistic tendencies.<sup>3</sup>

A public pension system can be privately run. Then it is a kind of public-private partnership. Using private providers of pension services does not necessary mean privatisation of the pension system. Goals, methods, regulations and supervision are provided by the state while services themselves are delivered by the private sector.

## 2.8. Workers and retirees as voters

The pension system is important for both the active and the retired generation, while in public perception the system is for the retired. Consequently, the retired generation (supported by those who are in say “pre-retirement” age) is very sensitive to everything related to the system. While the younger part of population simply ignores majority of pension system related issues. It is psychologically understandable but allows for neglecting interests of the workers.

Population structure in developed countries has substantially changed throughout recent decades. In short, the ratio of the number of pensioners to the number of the employed has substantially increased. Demographic projections show the tendency will continue. Fertility is low and even if it can be slightly improved, the past levels will never be reached again. People live long and life expectancy will continue increasing in the decades to come. Consequently, the financial pyramid traditional pension systems are based on would be bankrupt if private sector regulations were applied to the public one. However, this is not the case, which means that pension systems are still treated as if they were properly working.

Elder people are more disciplined voters than younger ones. That is probably because of tradition and values but also because their interest is easy to understand. Median voter is getting older. Do that contribute to creation of “gerontocracy”? Some studies conclude this

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<sup>3</sup> The meaning of the term “etatism” used here is just the opposition of the term “subsidiarity”.

is not the case.<sup>4</sup> However, they analyse whether societies move towards higher valuation of interests of the old. European (at least European) societies moved in that direction long time ago. That time it was cheap for the working generation. Now it is not cheap any more. It is expensive and keep becoming even more expensive. It would be justified if societies start reducing the costs for the young or at least try to stop that increase. It is difficult to achieve, which – in my opinion, is a sign of gerontocracy.

## 2.9. Transition cost

Pension reforms are either parametric or if structural or “paradigmatic” then focused on implementation of a funded tier. The latter does not need to be so narrowly understood. The NDC type pension reform is also possible and maybe even better. However, if it is funding then the so-called transition cost appears.

It is commonly assumed that introducing funding to the pension system implied the so-called double burden for the current working generation that is to save for own pensions while being forced to keep paying for pensions of the current generation of pensioners. That is a result of applying cash accounting to public finance. In fact there is no additional cost imposed by funding that can be interpreted as advance buyout of future liabilities. However, since that looks as an additional expenditure it pushes out other expenditure from the budget. From the economic viewpoint that is fine since the generating inflation debt caused by real expenditure is exchanged for non-generating inflation debt. Those who want to spend more today are not fans of such exchange, of course (given restrictions on indebtedness). If public finance applied accrual accounting then the transition cost would disappear.<sup>5</sup>

Many of the issues shortly mentioned in Section 2 are difficult since the general public, hence also politicians, misinterpret their own interest. Public education is one of crucial factors labour market and social reforms are conditioned on. Some other of the issues need

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<sup>4</sup> See Tepe, and Vanhuysse, 2009.

<sup>5</sup> This topic goes beyond the scope of this paper.

more economic based expert discussions. Section 3 presents the way these issues were discussed and partially turned into the design of the new pension system.

### **3. The interests turned into the design of the new pension system**

Pension reform was designed promoted and introduced in times of late transition. That helped a lot since the transition was the process that was just going on itself. However, the pension reform had nothing to do with the transition from planned to market economy.

Public education is the best supporter of social and labour market reforms. Initially, in years 1996-2000 public education was partially provided by media. However, it is impossible to educate entire society to the extent that would be sufficient for a merit-based discussion. Consequently, many issues have not been explained well enough.

The general design of the new system is in line with general expectation of the society, at least the ones expressed that time. Opinion polls clearly showed the public desired a system in which benefits depend on contributions and the contributions themselves should go through financial markets in order to let people benefit from profits.

The new system was designed in a very unusual situation when the designers were free to design the best in their view system with very little constraints from politicians. That let to design and implement a very radical reform that actually should be not be called the reform but rather an exchange of the existing system for a new one design from the scratch.

The key goal was to balance interest of the workers and of the retirees. In other words interests of each generation in both phases of their participation in the pension system. The new system was entirely based on individual accounts and partially linked to financial markets. The former leads to intergenerational equilibrium, the latter brings into the system diversification of risks.

The shortest description of the new system:

Everybody receives back in the form of annuity the present value of contributions paid.



$PV(b) = E[PV(c)]$  and consequently  $PV(B) = PV(C)$

Where PV – present value; b – individual benefits; B – aggregated benefits; c – individual contribution; C – aggregated contributions

The reform went along the following lines:

- ✓ Focusing on the mandatory part of the pension system;
- ✓ Separation of the old-age part of social security (OA) from the non-old-age parts of social security (NOA); and segmenting the flows of revenue (contributions are separated);
- ✓ Termination of the OA part of the previous system;
- ✓ Creation of a new OA pension system, entirely based on individual accounts;
- ✓ Accrual accounting within the OA system;
- ✓ Splitting each person's OA contributions between two accounts (first account – NDC, second account – FDC);
- ✓ Annuitisation of account values (NDC as well as FDC) at the moment of retirement;
- ✓ Minimum pension supplement on the top of both annuities if their sum is below certain level (financed out of the state budget).

There is no typical social redistribution in the system. Otherwise it would not be possible to receive the present value of contributions paid. Redistribution remains present in the society but it has been moved from the pension system to the state budget, which is better for both the system and the redistribution. The system becomes transparent and easy to understand. Redistribution is financed out of broader base that include not only labour income but also profit. It is also important that general revenues are based on at least partially progressive taxes while social security is based on linear contributions.

In the new system a cap on contributions was introduced. After a sum of contributions paid by or for a person reach the amount thirty times more than average monthly wage/salary

then contribution payment stops. This is a result of removing redistribution from the pension system. It does not make sense to force the richest people to save more in the public system. Let them do that themselves outside the system after paying income tax due.

In the past before the new system was introduced contributions had been constantly increasing. Until 1981 the overall social security contribution was 15.5 percent. In mid 1990s the rate reached 45 percent. Projections suggested the trend would remain for the decades to come. Since the new system was introduced the increase was stopped which means net remunerations can grow stronger. For the time being we have to pay back debts of the old system but the debt do not grow any more beyond the level that can be automatically financed without the need to increase contributions or taxes.

Contributions do not increase which means there is more room for individual savings. If the old system had not been terminated the contribution rate would have been higher. It is not and we are free to save more ourselves. At the same time there is virtually no tax incentive for additional individual savings.<sup>6</sup>

**4. Three important pieces of statistical information**

4.1. Pension system expenditure projections

Traditional pension systems absorb growing part of GDP. Societies have less GDP left for other purposes. That is a result of population ageing (mostly). Table 1 provide European Commission projections of pension expenditure in the member states for the period up to 2050.<sup>7</sup>

Table 1. Projection of pension expenditure made out of public finance as percent of GDP

Country	2004	2025	2050	Δ(2050-2004)
Belgium	10.4	13.4	15.5	5.1

<sup>6</sup> Financial institutions keep trying to have incentives available, which would improve their business opportunities.

<sup>7</sup> There exists revisions of the projections but they differ in details not in general trends.

Czech Republic	8.5	8.9	14.0	5.6
Denmark	9.5	12.0	12.8	3.3
Germany	11.4	11.6	13.1	1.7
Estonia	6.7	5.1	4.2	-2.5
Greece	n.a.	n.a.	n.a.	n.a.
Spain	8.6	10.4	15.7	7.1
France	12.8	14.0	14.8	2.0
Ireland	4.7	7.2	11.1	6.4
Italy	14.2	14.4	14.7	0.4
Cyprus	6.9	10.8	19.8	12.9
Latvia	6.8	5.3	5.6	-1.2
Lithuania	6.7	7.6	8.6	1.8
Luxemburg	10.0	13.7	17.4	7.4
Hungary	10.4	13.0	17.1	6.7
Malta	7.4	10.0	7.0	-0.4
Netherlands	7.7	9.7	11.2	3.5
Austria	13.4	13.5	12.2	-1.2
<b>Poland</b>	<b>13.9</b>	<b>9.5</b>	<b>8.0</b>	<b>-5.9</b>
Portugal	11.1	15.0	20.8	9.7
Slovenia	11.0	13.3	18.3	7.3
Slovak Republic	7.2	7.3	9.0	1.8
Finland	10.7	13.5	13.7	3.1
Sweden	10.6	10.7	11.2	0.6
United Kingdom	6.6	7.3	8.6	2.0

*Source: European Commission (2006).*

The projections show among others that Poland belongs/belonged to countries spending the most on pensions at the beginning of the century. However, Poland is the country where expenditure will decrease as opposite to most other European Union countries where the expenditure will keep increasing (in some countries it is projected to increase really a lot). With respect to Poland the effect stems from: (1)  $PV(B) = PV(C)$  and (2) partial funding, which means costs of future pensions are prepaid now. Table 1 clearly show that the reform was needed in Poland more than in most other countries. The table also show that the goal of the reform may be reached.

#### 4.2. Tax wedge

High and increasing costs of financing the pension system led to high tax wedges in Poland.<sup>8</sup>

Table 2 illustrates that. Moreover, these are typical families who bear the cost.<sup>9</sup> Hopefully the cheaper pension system will let to reduce that cost.

Table 2. Tax wedge (family with two children and average wage)

	2000	2005	2006
Australia	22,7	16,0	16,0↓↓
Austria	35,2	36,4	36,9↑
Belgium	42,6	40,1	40,1↓
Canada	23,9	21,5	22,8↕
Czech Republic	22,7	27,2	26,1↑
Denmark	31,0	29,2	29,5↕
Finland	40,7	38,3	38,0↓
France	40,7	41,8	42,0↑
Germany	37,4	36,1	36,2↕
Greece	39,8	40,8	41,5↑
Hungary	43,9	40,7	39,8↓
Iceland	5,7	11,1	10,4↕
Ireland	15,5	5,8	2,3↓↓↓
Italy	38,0	35,1	35,1↓
Japan	21,1	25,0	25,8↑
Korea	15,7	16,2	16,8↑
Luxemburg	15,4	12,6	13,0↕
Mexico	12,6	14,7	15,0↑
Netherlands	29,6	29,7	37,0↑
New Zealand	13,6	14,4	2,6↓↓↓
Norway	28,4	29,6	29,9↑
<b>Poland</b>	<b>38,8</b>	<b>41,9</b>	<b>42,2↑</b>
Portugal	30,2	26,6	26,6↓
Slovak Republic	30,5	23,1	23,7↓↓
Spain	32,1	33,2	33,6↑
Sweden	44,3	42,7	41,8↓
Switzerland	18,7	18,6	18,9↕
Turkey	40,4	42,8	42,8↑
UK	27,2	27,5	27,8↕
US	15,5	11,0	11,7↓
OECD*	28,5	27,7	27,5↓
EU-15*	33,3	31,7	32,1↕

<sup>8</sup> Other expenditure via public finance also matter.

<sup>9</sup> In 2008 that cost was slightly reduced, which is not related, however, to the pension system.

EU-19*	33,5	32,0	32,3↕
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\*Non-weighted average

Source: OECD Taxing Wages, 2007

#### 4.3. Risk of poverty by age

The projected reduction of pension expenditure may suggest pensioners will be pushed into poverty. Table 3 illustrate they are not a group the most exposed to poverty in Poland.

Other way around, they are much less exposed as compared to younger groups. The distribution of poverty risk looks in Poland really strange.<sup>10</sup> People above 65, of whom the vast majority are pensioners is much less exposed to the poverty risk than prime age workers, of whom the vast majority works and pay contributions. The poverty risk among children is to a large extent a consequence of poverty among working families.

The expected reduction of the replacement rate can be at least partially justified not only on sustainability grounds but also from the point of view of social policy.

Table 3. Risk of poverty by age group in the EU (2005)<sup>a</sup>

Age group	0-15	16-24	25-49	50-65	65+
EU25	20 <sup>b</sup>	21 <sup>b</sup>	14 <sup>b</sup>	13 <sup>b</sup>	(18 <sup>b</sup> )19
EU15	20 <sup>b</sup>	21 <sup>b</sup>	14 <sup>b</sup>	13 <sup>b</sup>	(19 <sup>b</sup> )20
Belgium	19	17	11	11	21
Bulgaria	22 <sup>b</sup>	20 <sup>b</sup>	14 <sup>b</sup>	10 <sup>b</sup>	16 <sup>b</sup>
Czech Republic	18	12	11	6	5
Denmark	10	29	10	5	18
Germany	13	14	12	13	15
Estonia	21	18	16	18	20
Ireland	22	19	14	20	33
Greece	19	23	15	18	28
Spain	24	18	16	17	29
France	14	18	11	10	16
Italy	24	23	16	15	23
Cyprus	12	12	10	14	51
Latvia	21	19	17	20	21

<sup>10</sup> Similar pattern can be observed in some other countries but only to much lesser extent.

Lithuania	27	23	19	18	17
Luxemburg	20	15	13	8	7
Hungary	19	17	14	10	6
Malta	22	11	13	13	15
Netherlands	16	16	10	8	5
Austria	15	13	11	10	14
<b>Poland</b>	<b>29</b>	<b>26</b>	<b>21</b>	<b>16</b>	<b>7</b>
Portugal	24	20	17	18	28
Romania	25	22	16	13	17
Slovenia	9 <sup>c</sup>	11 <sup>c</sup>	8 <sup>c</sup>	9 <sup>c</sup>	19 <sup>c</sup>
Slovak Republic	18	17	14	8	7
Finland	10	22	8	9	18
Sweden	8	23	8	5	11
UK	22 <sup>c</sup>	18 <sup>c</sup>	13 <sup>c</sup>	16 <sup>c</sup>	24 <sup>c</sup>

<sup>a</sup> The share of persons with an equivalised disposable income below the risk-of-poverty threshold, which is set at 60% of the national median equivalised disposable income (after social transfers).

<sup>b</sup> Data for 2004

<sup>c</sup> Data for 2003

Source: Eurostat.

The new pension system does not necessary reduce pensions. Everything depends on the age of retirement. For those who postpone retirement and keep working for a couple of years more the new system will generate relatively high replacement rates. The new system is actuarially neutral which is good for those who work long and bad for those who retire early. In the previous system it was exactly the opposite.

## 5. Bridging pensions – the most difficult part of the struggle for the reform

Population ageing, although going on quickly, is not as advanced as in majority of other European countries. So the scale of expenditure being among the highest is not only demographically driven. The other factor is generosity of the previous system. That generosity had at least two components:

- ✓ Relatively high replacement rate (60-70 percent)
- ✓ Easy available early retirement possibilities

Now I discuss the latter issue. Although the nominal retirement age in Poland is 60 for women and 65 for men only around 20 percent of workers retire after reaching that age. Actual exit age was around 55 for women and 59 for men. That was possible thanks to various regulations that originated from the past (majority were granted just after the Martial Law in 1981). Consequently, employment ratio in Poland was and still is one of the lowest in the EU (below 60 percent).

In the new system early retirement was abolished. The law bills enacted in 1999 did not have any provisions for that. It looked great and some experts suggested just to keep that regulation. Another option won, namely bridging pensions for certain occupations. They are well defined. Only a limited number of those who were able to retire early kept that possibility. It was impossible to expect people advanced in their working life would be able to retrain and work until 60/65. Trying to keep that may have led to social unrest and danger for the entire new system. Implementing the law on bridging pensions was strongly opposed by trade unions and many politicians, including the President. Bridging pensions justify the large shift of the actual retirement age.

Bridging pensions themselves do not offer much. Access will be very restricted (only medically defined occupations in special conditions or in special capacity) and their level will be limited. The bridging pension system is kept outside the universal pension system, which is crucial. Their cost will be co-financed by employers employing workers in conditions leading to the need of using the bridging pension. And finally, they will be limited in time.

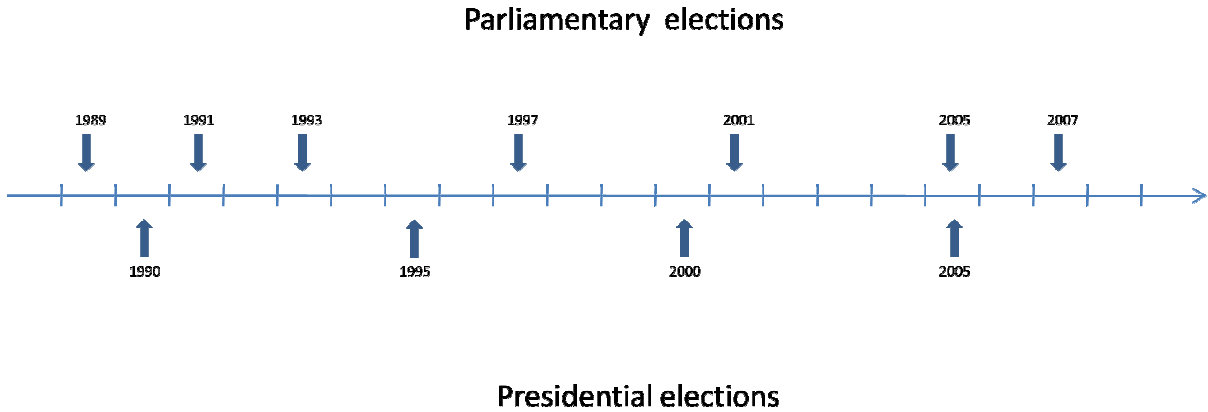
Adopting the Law on bridging pensions was one of the crucial moments in reforming pensions in Poland. Longer work activity will mean higher pensions and larger labour supply.

## **6. Political scene**

The reform would have never been possible if political situation had not allowed for that. It was very unusual situation that let design and implement such a radical pension reform.<sup>11</sup>

As in many, actually most Central European Countries the political scene has been relatively unstable. Majority of ruling coalitions have not survived until consecutive elections. Typically former election winners become losers in next elections. In Poland that instability is additionally fuelled by unclear division of responsibilities between Government and President. Figure 2 illustrate timing of political changes in Poland from 1989 till now. Table [...] in Annex provides detailed information on election results.

Figure 3. Election timing (1989-2009)



Parliamentary elections:

1989 – first semi-free elections, followed by creation of the first non-communist government of Tadeusz Mazowiecki

1991 – won by a broad coalition of post-Solidarity parties (mostly right-oriented, at least nominally)

1993 – won by post-communist coalition (mostly left-oriented but at the same time pretty liberal and EU-oriented)

<sup>11</sup> Description of the whole political process goes beyond the scope of this paper. That process is extensively described in Orrenstein (2008).



1997 – won by a coalition based on Solidarity trade union plus liberal-democrats (Unia Wolności) (mostly right-oriented, reform-oriented, EU-oriented)

2001 – won by a left-oriented coalition (partially liberal, strongly EU-oriented) 2005 – won by a right-oriented coalition (rather nationalistic and populist, etatistic, ideology-driven, EU-sceptical)

2007 – won by a centre coalition (EU-oriented, liberal)

Next Parliamentary elections will be in 2011.

#### Presidential elections:

1990 – won by Lech Wałęsa

1995 – won by Aleksander Kwaśniewski

2000 – won by Aleksander Kwaśniewski

2005 – won by Lech Kaczyński

Next Presidential elections will be in 2010.

It is very difficult to judge whether the election outcomes really affected economic and social developments. Probably in some cases that was the case (for instance the elections of 2005). However, that does not depend on typical right-centre-left division of the political scene. This is rather openness for reforms and modernisation what has really differentiated governments since 1989.

On that general picture the pension reform looks pretty good. All governments since 1996, when designing of the new system started, supported or at least did not substantially destroy the initial design of the system. There were exceptions, however.

First was in 1997, when politicians withdraw prosecutors from the universal system.<sup>12</sup>

Second was in 2002, when the so-called uniform services (army, police, firemen and some other groups) were withdrawn from the universal system.

Third was in 2005, when furious protests of miners pushed politicians to accept their will to move out of the universal system.

## **7. Trade unions**

In communist economies practically all workers in state own enterprises were members of official trade unions (practically around 80 percent). That changed in 1980 when there was a large shift towards “Solidarity” membership (above 7 millions – which was above 60 percent of , while in the formerly official 1 million – around 8 percent). However, trade unions played mainly political role that time, which came back at the beginning of transition. “Solidarity” became political background for first three governments. It consequently supported and promoted market reforms, while traditional trade union activities were marginalised.<sup>13</sup>

Trade union coverage has been decreasing since 1989. Union density drop from 53.1 percent in 1989 to 14.7 percent in 2001 (the latter belongs to the lowest levels in the world). Same process observed throughout the world, however, to lesser extent.<sup>14</sup> Erosion of trade unions is a function of a number of factors of which two factors seem the most important: (1) privatisation and (2) a shift from large firms operating in declining industries towards medium and small firms operating mostly in services.

Trade unions focus on interest of the workers. That is interpreted in a way including pension rights. So trade unions typically support more generous rules. That mean the unions opt for weaker growth of net wages (given the structure of other public expenditure). It is difficult to have trade unions on the reform side.

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<sup>12</sup> Judges have their own system guaranteed by the Constitution. Prosecutors do not but their pressure was efficient enough to be treated as if that was the case.

<sup>13</sup> See Gardawski, et al. (1999).

<sup>14</sup> See Visser (2006)

Trade unions either supported (Solidarity) or were neutral (OPZZ) towards the pension reform. That was a very important factor behind the success of the reform. The new system was perceived as a kind of improvement in the area of protecting workers rights.<sup>15</sup>

Since that time (1997-1999) position of trade unions has shifted towards more critical one. Typical unionist approach came back (paying pensions is obligation of the state, which should not negatively affect workers).

Trade unions (all of them, thou trying not to co-operate) took two big antireform actions in the 2000s. The first in 2005 was focused on miners privileges. The action was taken at the moment just before presidential and parliamentary elections. The action was extremely brutal at Polish standards. Politicians did not want to oppose. Since that moment miners stay outside the universal pension system. Plans to bring them back are not on the agenda at the moment.

Another action was taken in late 2008. The goal was to block termination of pension privileges of other groups. The law bill on the so-called bridging pensions practically abolished early retirement for the vast majority of workers. That action failed. Even President's veto was rejected and the law was enforced.

## **8. Key factors behind the success of the pension reform in Poland**

Pension reform is a difficult challenge. Success is not guaranteed. Actual experience indicates that failure is rather very likely. Recent evidence from many European countries illustrates this very clearly. However, Poland's case is a success. How was this possible? Here are key factors that helped:

- The new system was designed by economists, who were able to focus on inputs, outputs and means of the system (rather than by traditional social security experts, who tend to focus mostly on outputs of the system);
- The reform team was decoupled from politics, and understood to be made up of non-political specialists;
- The new system was designed without pre-set political guidelines;

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<sup>15</sup> For a broad analysis of the situation see Orrenstein (2008).

- The reform team enjoyed political protection from various political powers, under various governments;
- The reform project was presented to the public without strong political affiliation;
- The reform team was not linked to institutions involved in running the old pension system;
- Pre-reform rationalization of the system was not presented to the public as a reform;
- The new system was presented to the public as a new opportunity (actuarial link of contributions and benefits), not as cutting down old system promises;
- Strong marketing of the new system (media, social partners);
- The new system was designed and implemented before the real pension crisis started;
- The reform did not affect pensioners and workers already close to retirement;
- The reform did not increase labour cost;
- The old system was terminated but pension rights acquired under its rule were not lost or reduced.

## **9. Conclusion**

The labour market in Poland was subject to many changes since 1989. Majority of them followed European experience. Eventually, after twenty years Polish labour market is much closer to ones in other EU countries. The most optimistic is that unemployment in Poland went down from the highest European levels to around average or even slightly below. Much less optimistic picture come from data on employment that still is low at European standards and much below the Lisbon target.

The employment rate need more time to increase than the unemployment rate to decrease. The pension reform briefly presented in this paper will contribute to that in the longer-run.

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## Appendix

Table A1. Employment rate (1989-2009)

	employment rate
1992	0,533
1993	0,521
1994	0,510
1995	0,507
1996	0,512
1997	0,515
1998	0,510
1999	0,480
2000	0,474
2001	0,455
2002	0,441
2003	0,442
2004	0,451
2005	0,459
2006	0,475
2007	0,495
2008	0,510
2009	

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Table A2. Unemployment (1989-2009)

	<b>unemployment rate (registration)</b>	<b>unemployment rate (LFS)</b>	<b>unemployment rate (LFS - yearly ave)</b>
1989			
1990	6,1%		
1991	11,4%		
1992	13,6%	13,7%	
1993	16,4%	14,9%	
1994	16,0%	13,9%	
1995	14,9%	13,1%	
1996	13,2%	11,5%	
1997	10,3%	10,2%	
1998	10,4%	10,6%	
1999	13,1%	15,3%	
2000	15,1%	16,0%	
2001	19,4%	18,5%	
2002	20,0%	19,7%	
2003	20,0%	19,3%	19,6%
2004	19,0%	18,0%	19,0%
2005	17,6%	16,7%	17,7%
2006	14,8%	12,2%	13,8%
2007	11,2%	8,5%	9,6%
2008	9,5%	6,7%	7,1%
2009			

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Table A3. GDP index (1989-2009)

	<b>GDP index</b>
1989	100,2
1990	88,4
1991	93
1992	102,6
1993	103,8
1994	105,2
1995	107
1996	106
1997	106,8
1998	104,8
1999	104,1
2000	104,3
2001	101,2
2002	101,4
2003	103,9
2004	105,3
2005	103,6
2006	106,2
2007	106,7
2008	104,8
2009*	101,4

\*Projection

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Table A4. Life expectancy (1989-2009)

	at birth		at 65	
	F	M	F	M
1989	75,5	66,8	19,9	15,4
1990	75,24	66,23	16,09	12,42
1991	75,06	65,88	15,89	12,27
1992	75,48	66,47	16,17	12,53
1993	75,81	67,17	16,17	12,55
1994	76,08	67,50	16,41	12,77
1995	76,39	67,62	16,55	12,88
1996	76,57	68,12	16,53	12,93
1997	76,99	68,45	16,79	13,14
1998	77,34	68,87	17,02	13,37
1999	77,49	68,83	17,11	13,28
2000	78,00	69,74	17,46	13,63
2001	78,38	70,21	17,72	13,92
2002	78,78	70,42	18,04	14,05
2003	78,90	70,52	18,08	13,98
2004	79,23	70,67	18,39	14,23
2005	79,40	70,81	18,56	14,37
2006	79,62	70,93	18,76	14,51
2007	79,74	70,96	18,89	14,55
2008	79,96	71,26	19,04	14,73
2009				

[http://www.stat.gov.pl/gus/5840\\_894\\_PLK\\_HTML.htm](http://www.stat.gov.pl/gus/5840_894_PLK_HTML.htm)

Table A5. Polish governments (1989-2009)

	<b>prime minister</b>	<b>period</b>
1	Tadeusz Mazowiecki	12.09.1989-12.01.1991
2	Jan Krzysztof Bielecki	12.01.1991-23.12.1991
3	Jan Olszewski	23.12.1991-10.07.1992
4	Hanna Suchocka	11.07.1992-26.10.1993
5	Waldemar Pawlak	26.10.1993-6.03.1995
6	Józef Oleksy	7.03.1995-7.02.1996
7	Włodzimierz Cimoszewicz	7.02.1996-31.10.1997
8	Jerzy Buzek	31.10.1997-19.10.2001
9	Leszek Miller	19.10.2001 - 02.05.2004
10	Marek Belka	02.05.2004 - 31.10.2005
11	Kazimierz Marcinkiewicz	31.10.2005 - 14.07.2006
12	Jarosław Kaczyński	14.07.2006-16.11.2007
13	Donald Tusk	16.11.2007-