VOLUNTARY PENSION SAVING IN CEE COUNTRIES: POSSIBILITIES FOR ENHANCEMENT

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ABSTRACT

Voluntary pension saving, or the third pillar of the pension system in CEE countries, can be seen as an enhancement of pension benefits based on the two mandatory pillars of the pension system. In Croatia, less than 10% of citizens opt for this savings option, with the average amounts saved being very low and insufficient to ensure a significantly better standard of living in old age. Nevertheless, the performance of voluntary pension funds can be considered satisfactory and there are favourable government incentives and better tax treatment of pension saving compared to other forms of saving. Voluntary pension saving is the only financial product in the Republic of Croatia that includes state incentives, fund returns and tax relief for employers. Considering the low level of coverage and contributions within the voluntary pension pillar in Croatia, but also in other CEE countries, the question arises as to the possible reasons for the low interest of employees in this type of saving. This is due to low financial literacy, lack of long-term predictable and transparent government policies and other unfavourable economic and social factors. The aim of this article is to present effective tools to promote pension saving and achieve higher participation in voluntary pension schemes. Research findings suggest that, in addition to traditional tax incentives, there are some new, effective types of financial (non-tax) incentives that are better suited to low-income savers, who are in the minority in the overall population of voluntary pension savers. These efforts should continue in the coming years and have an impact on the general attitude towards money and saving and thus on the overall financial behaviour of citizens.

Keywords: *CEE countries, pension system, financial literacy, incentives, voluntary pension saving*

1. INTRODUCTION

Systematic pension reform in Croatia began with the 1998 Pension Insurance Act, which laid the foundation for the transition from the then exclusively public pay-as-you-go benefit system to the current mixed-pillar pension system. However, the expected results of this reform did not quite materialise as initially anticipated, leading to further interventions in 2002, 2015 and 2018. This underlines the ongoing need to improve pension systems in all EU countries after the transition, especially in those countries that reformed their pension systems by upgrading the existing pay-as-you-go (PAYG) model additional with two pillars consisted of mandatory and voluntary pension funds, especially in the late 1990s and early 2000s when they faced problems such as unfavourable demographic trends, huge financial pressures and public pension insolvency (Olgić Draženović, Hodžić, Maradin 2019).

Therefore, most of the Central and Eastern European (CEE) governments implemented a three-pillar pension reform based on the World Bank model during the first fifteen years of transition. But the outbreak of the global financial crisis triggered the second comprehensive wave of changes in the pension system. Most countries from CEE decided to modify the existing pension system, ranging from minor (or no) modifications to radical pension reforms of the institutional framework, regulation, and structure of old-age pension systems. The changes were more pronounced in the second pillar, reducing the amount of contributions paid into mandatory pension funds, changing the rules for fund participation, or even nationalizing the second pillar (Bielawska, Chłoń-Domińczak, Stańko, 2017; Olgić Draženović, Buterin, Suljić Nikolaj 2019). It can be concluded that the limited scope of contributory pension systems is a serious economic and social problem, and therefore one of the viable options for the future sustainable development of pension systems and ensuring adequate pensions is to strengthen voluntary pension saving. In doing so, it is particularly challenging to address the low levels of coverage and contributions and the low level of interest among workers in this type of saving. Jackson (2017) points out that "emerging economies' success in ensuring retirement security will increasingly depend on their ability to build robust voluntary pension systems." Moreover, the long-term costs of maintaining a generous and strong third pillar are far lower than the costs of public pensions, and reversing the implemented reforms could actually worsen the already high fiscal burdens and pension adequacy. This article aims to explore the potential of voluntary pension saving in CEE countries to increase coverage and identify possible solutions to overcome researched obstacles to development. Therefore, the authors assess and provide an overview of the main proposed strategies and policies that have been recommended or already implemented. The article is organized as follows. After the introduction, Section 2 briefly describes the design of pension systems from CEE and focuses on the development of voluntary pension savings. Section 3 assesses the factors responsible for the underdevelopment of these institutions and the low interest of workers in this type of saving. Section 4 examines and compares the model of financial incentives aplicable in CEE countries. Finally, in section 6 we draw a conclusion.

2. OVERVIEW OF VOLUNTARY PENSION SCHEMES IN CEE COUNTRIES

All of analyzed CEE countries introduced the third pillar with a comprehensive pension reform aimed to add capitalized saving to PAYG system. The first CEE country that implemented supplementary elements of old-age pension system was the Czech Republic (1994). Few years later it was followed by Slovakia (1996), Poland (1999), Bulgaria (2002), Croatia (2002) and Romania (2007). In case of Poland, the third pillar was substantially broadened in 2004 and 2012. Old-age provision offering additional income at retirement, operates in form of a voluntary occupational pension fund (Bulgaria, Poland) or a voluntary individual pension plan (Bulgaria, Croatia, Czech Republic, Poland, Romania and Slovakia). Depending on the type of a plan, the contribution may be paid in by an employee, an employer or by both parties (Rutecka-Góra 2016). Main features of the voluntary pension systems in selected CEE countries is shown in Table 1.

Table following on the next page

Country	Introduction	Main features of the system
Bulgaria	2002	Voluntary supplementary pension funds Voluntary professional pension funds
Croatia	2002	Voluntary supplementary pension funds
Czech Republic	1994 2013	Supplementary Pension Savings and Insurance: Transformed Funds Supplementary Pension Savings Schemes: Participating Funds
Poland	1999 2004 2012	Occupational pension programmes (PPE) Individual Retirement Accounts (IKE) Individual Retirement Savings Accounts (IKZE)
Romania	2007	Voluntary private pensions
Slovakia	1996	Voluntary private pensions

Table 1: Elements of supplementary old-age pension systems in selected new member EU countries
(Source: prepared by authors based on Rutecka-Góra 2016)

However, two decades after the introduction of the voluntary savings pillar in CEEs pension systems, they are still underdeveloped and very few people opt for this savings option, especially among low-income workers. In Croatia, for example, voluntary pension schemes had a total of 380 555 members at the end of 2020. This indicates a very low coverage rate within the third pillar: 24.9% of the working population or only 9.4% of the total population. The possibilities are much greater, especially considering that the total assets under management of voluntary pension companies (HRK 5.14 billion) represent only 2.6% of the population's savings and time deposits (in HRK and foreign currency) in banks in 2020 (Olgić Draženović 2021). The current concept of individual voluntary pension schemes in most CEE countries has resulted in low coverage, due to low income levels and low savings rates. The number of contributors is relatively insignificant and they are mainly high income individuals (Rudolph 2016).

3. REASONS FOR UNDERDEVELOPMENT OF VOLUNTARY PENSION SAVINGS

Voluntary pension saving in CEE is burdened by the low participation rate and the low contribution rates of participants. On the contributors side Bosch et. al. (2019) identify the inertia of participants in terms of portfolio management (indecision, lack of planning, irregular rebalancing of portfolios, etc.). For pension fund management companies there are evidence of inadequately diversified investment portfolios (performance chasing or containing too many individual investments such as stocks). These problems have a strong social responsibility aspect, as they are more common among low-income earners with low levels of education (Viceira, 2010). Pieńkowska-Kamieniecka (2013) identifies low financial literacy and inefficient tax incentives in the CEE region as the main factors for insufficient participation in supplementary pension schemes. Szczepański and Brzęczek (2016) also found evidence that stronger tax incentives encourage greater coverage of voluntary plans among the working-age population in the Czech Republic, Slovakia, Hungary, and Poland.

Table following on the next page

	Barriers	Solutions
Demand side	• Limited savings capacity • Intrinsic characteristics of formal retirement savings products • incompatible with individual needs (illiquidity) • Psychological factors (behavioral biases) • Lack of education related to personal finance and social security • Lack of a culture of social security rooted in sociocultural factors	• Behavioral interventions • Financial and social security education
Supply side	• Lack of commercial incentives to reach self-employed and low-income workers • High collection costs for micro deposits • Insufficient reach of deposit networks in rural areas	• Financial technology and innovation

Table 2: Barriers and solutions for voluntary retirement savings among low-income and independent workers
(Source: prepared by authors based on Bosch et. al. 2019)

In conclusion, factors undermining the development of voluntary pension schemes in CEE countries, given their comparable characteristics due to a similar historical and political evolution and a comparable financial system development path (Viceira 2010; Le Blanc 2011; Pieńkowska-Kamieniecka 2013; Szczepański and Brzęczek 2016; Bielawska et. al. 2017):

- low level financial literacy
- limited knowledge of the pension system (this influences workers' decisions regarding their pension savings),
- lack of fair, predictable and transparent government policies in the long run,
- economic factors - low income levels and unfavourable macroeconomic conditions,
- social factors (biheviour) - the average investor in CEE countries is risk averse and conservative (relying on traditional forms of savings),
- typical investor (saver) concerns - inflation risk, lack of control over investments, inflexibility of income.

4. POSSIBILITIES FOR ENHANCEMENT OF THIRD PILLAR IN CEE

In order to define and implement strategies for broadening and deepening the voluntary pension system of CEE, it is useful to draw from the experience of the developed countries. Le Blanc et. al. (2011) delivered comprehensive study of the institutional environment of voluntary pension accounts in eleven European countries (old members). They found evidence that wealth and high income increase the likelihood of paying into the third pillar, while high educational attainment is the most important determinant of saving. This supports the view of Jackson (2019) that pension literacy interventions are particularly important for low earners, who will have a low propensity to save for the third pillar.

Rudolph (2016) highlihts the main drivers of participation in funded schemes:
- compulsion: individuals are required to contribute to a pension scheme at a certain contribution rate,
- supply-side factors: these include the use of sales agents to encourage participation,
- positive peer pressure,
- soft compulsion.

Compulsion does not apply for CEE countries in terms of the given structure of pension systems and the voluntary accession of workers to these systems. In the supply-side method, the voluntary pension fund company works with the life insurance industry to stimulate demand for insurance products through its sales force and direct advertising. Often this method is used in conjunction with tax incentives. Nevertheless, this method is not suitable for CEE countries as it mainly targets high earners due to the higher potential commissions that salespeople can earn. This leaves a large proportion of middle- and low-income earners excluded from voluntary pension schemes. Positive peer pressure is a method often used in closed voluntary pension funds to increase the participation of low-income earners. This method relies on peers urging each other to enroll in pension plans. It requires influencing the decisions of passive savers, but only works if there are benefits to successfully "pushing" a colleague to enroll. This method requires a combination of tax incentives, matching contributions, and management persuasion. Soft compulsion methods are more sophisticated methods of encouraging participation. An example of this method would be automatic enrolment, where employers are required to sign their employees up to a voluntary pension scheme, but employees still have the option to opt out if they wish. This method takes advantage of the negative factors already mentioned as influencing low participation rates. These include inertia, indecision, procrastination, and passing over investment as a default option (Rudolph 2016). There are different approaches for enhancement of the voluntary schemes in CEE. These methods can be combined in otrder to be most effective. First and second approach include financial incentives i.e. tax and non-tax incentives. These direct financial subsidies are the most commonly used methods to encourage voluntary retirement saving. Historically, tax incentives have been the predominant type of incentive, but they are proven to be expensive to the government in terms of lost tax revenue. Furthermore, they are effective, but not a sufficient condition for a significant increase in voluntary saving. In Croatia, for example, voluntary pension saving is tax-advantaged compared to other savings products, as it includes government incentives, fund returns and tax relief for employers. However, in 2020 only 9.4% of the total population save in a voluntary pension funds which proves that this is not yet sufficient to attract significant funds and new members, and to noticeably improve the living standards and well-being of citizens. It seems that the greatest impact is on higher income groups, while the impact on less educated citizens with low levels of education is low, leading to distributional problems (Hinz 2019). Furthermore, lower income workers should be properly addresed because of their loss aversion and low trust in the system On the other hand, it is advisable to allow withdrawals allongside with defined limitation, penalization or discouraging to exit the system of voluntary saving. Second approach include financial non-tax incentives. They include matching contributions and nominal fixed subsidies paid into the retirement accounts of eligible individuals. Matching contributions are combining employer contribution based on the amount of workers annual contribution. Typically, employers match a percentage of employee contributions, up to a certain portion of the total salary. According to Rutecka-Góra et.al. (2018) matching contributions can provide a larger financial incentive than tax preferences, especially for employees who have low or zero marginal tax rates. Another option for policy makers could be to introduce automatic enrolment (default option) in voluntary schemes.

This method is based on behavioral economics. It involves workers enrolling in a pension plan by default, but with an option to opt out within certain time limits and under certain conditions. This policy harnesses the power of inertia and procrastination to keep people in the plan (OECD 2019). At the same time, the opt-out option retains individual choice and responsibility for the decision to participate in the plan. In addition, automatic enrolment is usually associated with default options for contribution rate, investment strategy, or the pension provider, allowing individuals who do not want to or cannot make a decision to join the pension plan without having to worry about these parameters. Thus, autoenrollment is based in part on the theory of suficient latent demand for pension coverage, but fixed costs, lack of knowledge about investing, and inertia may prevent workers from acting on that demand (Rutecka Gora, Vostatek, Turner 2018). In addition, some people who otherwise would not be interested in pension coverage may continue in coverage once they are automatically enrolled due to inertia, or perhaps, once covered they feel like it is the right thing to do Jackson (2019) notes that in addition to automatic enrolment, one of the world's best practices is auto escalation. He suggests setting the default rate low at the beginning and automatically increasing it over time because once enrolled in the plan, the average worker will stay in the plan out of inertia. On the other hand, one of the obstacles is that this method tends to be more costly for employers and governments than mandatory or voluntary opt-in arrangements. A study by Vanguard (2014) shows that automatic enrolment has little impact on participation in the highest income brackets. The impact is strongest among low- and middle-income earners, younger workers who are early in their careers, and men in general. Therefore, automatic enrolment provides broader and fairer coverage in obtaining a supplementary pension. Automatic enrollment has become mandatory for Polish employers (50-250 employees) starting in 2020. Enrolment for employees can be considered voluntary as they can opt out (resign) at any time. Compared to traditional state pension pillars, these schemes are based on cooperation between employers, employees and the state.

5. CONCLUSION

The design of the voluntary pension system and the implementation of appropriate government inventions are crucial to the creation of a stable pension system. Therefore, many CEE countries have taken measures to encourage additional saving for retirees and to make voluntary pensions a prominent feature of the pension landscape in the coming years. Since tax incentives have proven to be effective but not sufficient conditions for a significant increase in voluntary saving as policy measures to promote additional pension saving, it is therefore important to focus on non-tax incentives. In general, a combination of non-tax incentives and financial education should be pursued to achieve high coverage of voluntary retirement savings. One of the best options for strengthening the third pillar in CEE countries, based on the experience of developed countries, is automatic enrolment with an opt-out option. The system of voluntary private pensions and savings can ultimately become an important lever for economic growth, improving living standards in the third age and the welfare of citizens. Further improvement of voluntary pension systems in the CEE countries could be crucial both to achieve sustainability and adequacy of pensions and to find a remedy for overdependence on the state.

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