**Success factors of the pension reform**

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It is always exciting to start something new and Slovakia is living exciting times in this respect, having recently adopted the new pension legislation and facing the implementation of the second pension pillar.

Pension reform is a complex reform. The success depends on many factors and there are many things that can go wrong. To succeed one needs to have a good plan and even better implementation.

The current presentation will look into some factors, crucial for successful implementation of the pension reform, based on the experience of a similar reform in Estonia.

We know that neither Estonia nor the Slovak Republic were among the first in Central and Eastern Europe to initiate a comprehensive second pillar reform. From the other side, the experience of early reformers has taught important lessons on what can go wrong. For example, Poland had to face problems with the transfer of contributions to second pillar funds, registration of units and provision of information to second pillar participants. Hungary had to tackle with the associated political risks and their experience shows what problems may arise with the gradual attitude to pension reform. Now, the challenge for countries like Estonia and Slovakia is to become an example of successful pension reform without any major drawbacks.

Without going into details of the pension system, let us rather look into the general similarities and differences of Estonian and Slovak pension reforms. The first similarity is obviously the fact that both countries aim to establish a three pillar pension system, but besides this general framework, also the basic institutional set-up of different pillars is fairly similar. Also, the second pillar coverage rules in the two countries are similar. Joining of the second pillar is compulsory for new entrants to the labor market and optional for all current workers.

However, there are also differences. Firstly, the Slovak reform takes the so-called carve-out approach, the second pillar being established by dividing the former state pension contribution between the first and the new second pillar. At the same time, the Estonian second pillar reform combined the carve-out and top-up methods, the latter meaning an additional individual contribution of 2 percentage points (Leppik and Kruuda 2003). In spite of this, the total second pillar contribution rate in Slovakia is higher than in Estonia (respectively 9% and 6%).

While in Slovakia to receive a pension from the funded pillar, persons have to participate in the new system for at least 10 years (Melicherčik and Ungvarský 2003), the qualification period in Estonia is shorter – 5 years – and thus the first benefits from the system will be paid out earlier. Also, while in Slovakia the period of possible switching to the second pillar is limited to 1.5 years (from January 2005 to July 2006), in Estonia the possibility to join the second pillar for younger age cohorts is open at least to 2010.

The Estonian second pillar is somewhat more flexible for participants, e.g. although at any given year contributions can be directed to a single fund, it is not necessary to redirect previously paid contributions to a new fund when changing the fund. Thus over the full career, it is possible to accumulate contributions to several different funds.

The prudential rules in Slovakia are less conservative than in Estonia. In Estonia, there are principally no limits on investing abroad, while in Slovakia investment on the foreign markets may not exceed 50% of the funds' portfolio (Goliaš 2003). As a similarity of both countries, there are three categories of pension funds – growth funds, balanced funds and conservative funds, depending on the share of investments in stocks. However, in Slovakia growth funds may invest up to 80% of their assets in stocks, while in Estonia the maximum share of stocks is 50%.

The Estonian second pillar offers no direct guarantees on rate of return, but includes incentives for fund managers to maximize returns (e.g. compulsory participation in the fund) and a Guarantee Fund to cover any losses for fund participants due to breaches of investment rules, fraud etc. In contrast, the Slovak system includes a relative rate of return guarantee. The value of funds' assets will not be allowed to fall below 80% of the actual average value in other funds (Goliaš 2003).

In conclusion, the Estonian pension reform as compared to the Slovak reform is less radical in terms of the size, but slightly broader in personal scope. It is also more prudent in terms of investment policies, but more flexible for participants.

In Estonia, the three-pillar reform was launched 1997. The second pillar was implemented in 2002. Since the idea of funded pension schemes was something new for Estonia, it was considered that first some experience with the third pillar pension funds should be developed before second pillar funds are introduced. Retrospectively, if the reform had been implemented earlier, the probability of failure had been much higher.

There are obviously some pre-requirements for successful implementation of the second pillar. Firstly, the actors of the local financial market should have developed specific competencies. There should be competent asset managers, functioning securities market, Internet banking etc. Many of these features were still not very advanced back in 1997. Furthermore, people should have (at least basic) confidence in financial institutions. It was then also only good that the pension reform was not implemented before the 1998 stock market crash in Estonia or 1999 Russian financial crises. Although probably at some point of time the system will have to face a major crises in financial markets (it seams to be a natural law that these kind of crises appear from time to time), but it is obviously best if this does not happen in the first days of the new system.

When the basic conditions are satisfied, the further process can be mutually enhancing, i.e. the reform itself can develop financial markets further and also build confidence in the financial sector.

Besides the financial risks, the second pillar reform also has to take into account the political risks. The government, which finally implemented the second pillar in Estonia, was a third cabinet after the one which adopted the reform plan. Since in Estonia, as a rule, there are coalition governments made up from 2-3 political parties, in fact 6 different parties have been associated either with preparation or implementation of the pension reform. The involvement of different parties actually reduces the political risks of attempts to reform the reform or to make any substantial changes.

Obviously, also the parameters of the second pillar can reduce the political risk. Minimum degree of compulsion and a large degree of flexibility are features, which reduce opposition to the reform. This is relevant considering that there will always be strong opponents to such a substantial reform. These features also help selling of the reform, since the reform is not perceived as something "imposed from the top". People will have the option to "vote with their feet" and this kind of "voting" increases the political stability of the new system as the vote of people is always an argument in politics. However, the optional element also means

that people should have sufficient time to make up their minds. Too short deadlines may exclude some people from the new system (unless some groups, e.g. older generations are deliberately discouraged from joining).

Broad coverage across various age cohorts through voluntary joining is also an important political stabilizer of the second pillar from another aspect, although higher participation rate entails higher transition costs. With the higher rate of voluntary joining of the second pillar, it is more likely that voters of different political parties have joined the system. As an implication, parties are discouraged from making any significant changes in the system not to upset their voters.

In spite of being optional for the current work force and requiring an additional contribution of 2%, the second pillar in Estonia has turned out very popular. By the end of 2003 about 60% of the work force in Estonia had joined the new system.

What seem to have been the key factors of success? Firstly, psychological effects – it is important that the reform looks attractive. The Estonian reformers succeeded in turning the features, which possibly could had been perceived negatively, in their favor. What could had been perceived as an increase of the total contribution rate, was rather perceived as a bonus. The main slogan of the second pillar was: “You pay 2%, the state pays 4%”.

From my perspective, it was also good that the expected failure of the state pension system was not used as a main argument for the necessity of the pension reform. The state pension system also needs to survive and for this it also requires trust from the population. Instead of predicting the collapse of the state system, the messages mainly emphasized the new opportunities and potential benefits of the pension reform.

This leads as to the second crucial factor – selling of the reform by different actors: the state and fund managers. The proper role division between the actors is clearly important. The role of the state is mainly to campaign the general idea and provide neutral information. Probably more than it was done in the Estonian case, the state should provide information on what are the risks associated with the second pillar, allowing people to make an informed decision and minimizing false expectations.

Although the second pillar has been acclaimed to be the best selling product in Estonia in 2003, the best salesmen were actually not the bank tellers or fund salesmen who were professionally involved, but ordinary people who sold the idea to other people. Skeptical Estonians joined the second pillar, because many of their friends and family members had done so, and not so much because somebody at the bank told them that it would be a wise thing to do, or because they were promised a free beer or a warm blanket or to participate in a lottery to win a holiday trip – to give some examples of advertising tricks of Estonian pension fund managers. To reach the level that pension reform is broadly discussed in family circles it is therefore to gather momentum in public discussions.

Thirdly, transparency can be outlined as an important success factor of the Estonian reform. We are living at the time of Internet, which is a major channel of communication and of gathering information, in particular, for younger generations. Therefore, the system was established in a way that it is possible through Internet to join the second pillar, to choose a pension fund, to check the balance of the pension account, to see the investment portfolios of pension funds, to compare the performance of different funds etc. There is a special web site www.pensionikeskus.ee, which serves as the main entrance point for information on the second pillar, established by the Estonian Central Depository for Securities, which is the registrar of pension fund units.

And last, but not least, efficient implementing bodies and infrastructure is a crucial determinant of reform success. The bodies involved should be motivated and have sufficient administrative capacity to manage the tasks. Lack of motivation could be too costly for the whole reform. With these considerations, the task of co-ordinating the logistical side of the second pillar was given to the Estonian Central Depository for Securities, which is a private company in charge of the whole infrastructure for securities market in Estonia This institution has turned out to be highly efficient in setting up the necessary procedures, in providing information to fund participants and in solving the daily problems that have arisen in the implementation process.

The rhetoric of necessity of pension reform is often mainly associated with ageing of population, threat to public financing in the future etc. These are important and real considerations, but besides that, and perhaps, even more important is a public education aspect. The reform will change the paradigm, public perceptions on pension issues, focus of the pension debate. The reform will emphasize the importance of savings, customize many people to investment and encourage planning for one's own retirement.

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