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Pension reform in Slovakia

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PART 1: International Comparison

Practically, there exist three ways of providing old-age security: either by **taxes**, or by **saving** a stock of money (funded scheme), or by **insurance**, i.e. purchasing a promise of a share on future production (un-funded; often in the form of so called pay-as-you-go or PAYG scheme). In the funded scheme the workers save part of their income and accumulate these savings in order to use them after retirement. Both taxes and the insurance schemes are based on an intergenerational exchange, when current workers pay out current pensioners.

Different countries have a broad variety of pension systems relying on the tax, the PAYG, the funded schemes, or the combination of them. Some rely on the **"flat-rate" systems mainly financed by taxes** (e.g. United Kingdom, Switzerland, Netherlands, Ireland, and Denmark) providing a basic income irrespective of wages earned or contributions made. Other prefer the **"earnings-related" PAYG systems mainly financed by social security contributions** (e.g. Germany, Italy, France, Austria, Sweden) where pensions are related to past earnings, while at the same time a minimum pension is preserved. Furthermore, the countries with traditionally well-developed capital markets have at least partially relied on the **accumulation of savings** and investing them. Such countries, including USA, Great Britain and Netherlands, have developed a combination of usually "flat-rate" systems and (either mandatory or voluntary) funded plans, similar to the system recommended by the World Bank.[1]

In 1981 South-American Chile allowed for diverting all contributions from the PAYG to the mandatory and private fully-funded scheme. It began to accumulate individual savings on personal accounts and invest them into capital market securities. Starting with Chile's South-American neighbors (e.g. Peru – 1993, Argentina, Colombia – 1994, Uruguay – 1996, Bolivia, Mexico – 1997), many countries have implemented similar reforms and closed or at least diminished their PAYG. Facing the globalization, the ageing population problem and the high unemployment that all impose financial burden on the PAYG many post-communist countries (e.g. Kazakhstan, Hungary – 1998, Poland – 1999, Latvia – 2001, Croatia, Estonia, Russia – 2002) and some western democracies (Denmark – 1983, Switzerland, Netherlands – 1985, Great Britain – 1988, Australia – 1991, Sweden – 1996) introduced the mandatory funding. Most of them created a combined system of the PAYG and the funded pillars.

However, not all the countries are delighted with the idea of substituting their PAYG with the mandatory funding. Without any doubt, efficient PAYG has strong advantages that might explain its solid position in the continental Europe and countries with a mixed system. **Even the ageing population is not a "killer" for the PAYG - the efficient though not popular answer may be prolonging the retirement age.** Furthermore, a switch from the PAYG to the funded system requires huge transition costs that impose financial burden on the state budget.

[1] In its landmark report "Averting the Old Age Crisis" (1994), the World Bank set out a model based on three pillars: (1) tax-financed public safety-net; (2) compulsory saving by workers; and (3) voluntary saving.

For these reasons, many countries (e.g. Germany, Italy, France, Austria, Spain, the Czech Republic, and Slovenia) concentrate on improving their PAYG and supporting voluntary funded schemes rather than on designing the mandatory funding.

Reforming their PAYG, some countries such as Sweden, Germany, Italy, or Poland have introduced the **“Notional Defined Contribution”** (NDC) system. The principle, when current workers pay out current pensioners, remains the same. However, NDC brings two major innovations: (1) each individual has his/her own notional account, where life-long money inflows and outflows are recorded, and (2) the pension is calculated as an account remainder at the chosen time of retirement divided by an estimate of life expectancy for an individual of that specific age, i.e. it depends heavily on contributions paid during the working life.

Reforms in Central Europe: Hungary (1998), Poland (1999) and Slovakia (2004) have enacted major pension reforms that involve privatization of their national pension schemes, replacing them in part with funded systems of individual savings accounts managed commercially. In Hungary, the reform left the public PAYG almost untouched with excessive redistribution and absence of individual contribution records. On the other side, Poland implemented a system of notional accounts in which benefits will reflect individual contributions in a nearly linear way. Slovakia chose similar approach even though without notional accounts. It has also designed a combined system but compared to some other post-communist countries it shifts more progressively towards the mandatory funding (Table 1). In the Czech Republic and Slovenia, by contrast, governments have decided to reform their existing public PAYG systems without privatization. At the same time, they encouraged citizens to save for retirement in private pension funds on a voluntary basis.[2]

Table 1: Mandatory pension schemes across some post-communist countries

Country	**PAYG**	**Funded**	**“Funded” introduction**
	(% of gross earnings)		
Kazakhstan	0	10	1998
Hungary	22	6	1998
Poland	12.22+13	7.3	1999
Latvia*	18	2	2001
Croatia	14.5	5	2002
Estonia	16	6	2002
Russia**	24	4	2002
Slovakia	9+6+4.75	9	2005
Czech Republic	26	0	-
Slovenia	24.35	0	-

* Contribution rate for the funded pillar should gradually increase since 2007 up to 10% in 2010 reaching the same proportion for both pillars (10%+10%).
** Contribution rate for the funded pillar should gradually increase up to 6% resulting in 22%+6% in 2006.
Source: INEKO

PART 2: Reform in Slovakia

Slovakia implemented fundamental pension reform in 2004. The main drive for the reform was the widespread dissatisfaction with the pensioners’ standard of living. The public pension fund has been in deficit since 1997 causing a steady **decline in real pensions**. The average old-age pension in 2003 reached EUR 157, around 45% of the average wage in the economy,

[2] For more information on reforms in Central Europe (except for Slovakia) see the ILO – International Labor Office (2002): *Pension Reform in Central and Eastern Europe*, Volumes 1 and 2.

compared to 54% in 1991. The old system was **highly redistributive**. The difference between the lowest and the highest pension was minimal. The system was good only for low-income workers and speculators who worked in the shadow economy and paid just minimum contributions. This trend was further enhanced by **globalization process**, enabling high earners to avoid contributing to the system altogether. **Soaring unemployment** in late 1990's together with the **expected demography crisis** emphasized the need for the reform. Accepting the World Bank's recommendations and learning from similar reforms in Hungary and Poland, the new government decided to build a **pension system based on three pillars and a safety net for people with too low pensions.** The old PAYG system was split into the mandatory social insurance (1st pillar) and mandatory saving (2nd pillar) complemented with smaller reformed system of voluntary saving (3rd pillar). The solidarity was clearly separated and reduced to guaranteeing the subsistence minimum financed from taxes.

Reform of the PAYG – 1st pillar

The reform of the 1st pillar has brought these major innovations:

1. **Gradual prolonging of statutory retirement age** from the average 55 years for women (depending on number of children) and 60 years for men to the final 62 years for both genders. All men will retire at the age of 62 from 2006 and all women from 2015.

2. **New pension formula.** Compared to the old formula, the new one gives higher pension to those who earned more and paid higher contributions during their working life and vice versa. The redistribution is being reduced in a three-year transition period. The new calculation should increase motivation to pay contributions and eliminate evasion. Consequently, it brings a danger to **people with too low income, who will receive much lower pensions. They will be supported directly from the state budget. Thus, solidarity has been clearly separated from the mandatory contributions.**

3. **New indexation of awarded pensions:** So-called "Swiss method", i.e. automatic yearly valorization by the weighted average of the consumer price index (inflation) and the average nominal wage growth in the economy. The weights will be 0.5 for both parameters. Generally, changes in the indexation weaken political influence on pensions' calculation and bind them to the development of economic indicators. This is a good message, as the indexation often used to be a subject for political fight before the reform.

4. **Early and late retirement:** Unlike in former system, the reformed PAYG allows for early and late retirement. Each month of earlier retirement reduces a pension by 0.5% and each month of later retirement raises it by 0.5%.

Potential problems: Although the new PAYG strengthens the motivation, it does not react automatically on employment changes. These have crucial impact on collected contributions and represent key limiting factors for the amount of pensions. However, neither the pension calculation formula nor the indexation rules reflect these changes and **the system continues to give non-guaranteed promises**. Based on demography expectations, this problem might be relevant as soon as in 2015. **This would require another reform of the PAYG[3] including**

[3] This view supports also the OECD (2004) report: „The (PAYG) system remains nevertheless financially unsustainable in the long term. The planned defined benefit scheme with its strict link between contributions and benefits should, upon completion, transform workers' perception of pension contributions from quasi-taxes to

several options, among them further prolonging of retirement age, raising the contributions, change in the pension formula and/or change in the pensions' indexation (for example only by inflation which is expected to be lower than the wage growth).

Worth criticizing is also vain effort of Slovak reformers who wanted to build a universal system with the same rules for everybody. The resistance of armed forces (e.g. soldiers and policemen) was too strong and the privileges remained untouched. However, good news is that at least political agreement has been achieved to cancel these privileges.

Introduction of the Mandatory Funded System – 2nd pillar

The new mandatory "second" pillar will start on January 1, 2005. All citizens up to a defined age (approximately 52 years) will be allowed to choose to enter for the funded pillar until June 2006. Once entering, there will be no way back. Young people first entering the labor market will be obliged to go to the second pillar. Their assets will be managed by private pension companies competing on the market and supervised by an independent Financial Supervision Authority. The founders of pension companies will have to be credible financial institutions with at least 3-year experience. Minimum basic capital is set to SKK 300 million (EUR 7.1 million). Each one will manage three funds with different investment limits and different risk & return relationships (Table 2). Money paid to the second pillar will be a private hereditary ownership of savers. The interest earned on funds will not be taxed.

Table 2: Pension funds managed by pension companies

	Equities	Bonds & Money Market Instruments	Risk & Return
Growth fund	up to 80%	no limit	high
Balanced fund	up to 50%	at least 50%	middle
Conservative fund	no stocks	100%	low

Source: INEKO based on the Law on Old-Age Pension Savings

Investment portfolio: Equity is too volatile to provide stable income in retirement years, although it can be a valuable component of an investment portfolio during the accumulation phase. Bonds provide more stable income, at the cost of lower returns. For this reason, clients of pension funds invest primarily in equity, to gain the advantage of a large, though volatile return, and then shift gradually to bonds as the date of retirement approaches. In order to allow for such investment strategy, Slovak reformers require three different funds. Each saver may hold the assets only in one fund at the same time. Up to 15 years before retirement saver may not hold assets in the growth fund and 7 years before retirement it is required to completely shift assets to the conservative fund.

Guarantees: Directly, the state guarantees neither a specific performance of pension funds, nor the principal value of paid contributions. Indirectly, the law imposes strict investment limits on pension companies and secures strict regulation, but also requires the pension companies to achieve some minimum performance relative to their competitors. Moreover, the state guarantees 100% of granted pension in case of fraud or malefaction.

Investment restriction: According to law, the securities issued by Slovak emitters shall compose at least 30% of the funds' portfolio. The advocates of this limitation argued that it should "disable the outflow of domestic capital..., accumulate sources for investment into the

quasi-savings. Further changes in the PAYG system are desirable, notably the standard retirement age should be raised progressively to 65 for both genders."

Slovak economy..., and help to develop the Slovak capital market". However, most economists warn of the restriction's negative effects. Generally, it constrains choosing the best investment opportunities, having **negative impact on the rate of return and the amount of pensions.** Moreover, the restriction does not comply with the EU rules for free flow of capital and **limits the ability of the funded pillar to face the demography crisis.**

Transition costs: Introduction of the 2nd pillar causes high transition costs appearing in several coming decades. These costs are a big obstacle for many countries with strong PAYG pillars considering switching to the mandatory funding. Transition costs are a consequence of diverting contributions from the PAYG to the 2nd pillar – as a result the state receives less money but it still has to pay out the same pensions. Hence, transition costs depend positively on the contribution rate for the funded pillar and on the number of people switching. In Slovakia, these costs should be around 1% of Slovak GDP yearly (in 2005 circa SK 15 billion or EUR 0.36 billion). This is also a political commitment taken with respect to the Maastricht criteria for the adoption of common European currency.[4] There are several options how to finance transition costs: Large part will be covered from (1) the reformed PAYG that will generate higher revenues after prolonging the retirement age – **here the link between the introduction of the funded pillar and the need to prolong the retirement age is evident** – and that will generate sources in the public reserve fund (4.75% of monthly gross wage, preferably for covering the PAYG deficits). Other sources are (2) privatization revenues **(government has saved SKK 65 billion, or EUR 1.55 billion especially for this purpose)**, (3) state budget and (4) loans. The PAYG reserves and privatization revenues should cover all transition costs until 2011. However, the lack of money might appear earlier in case of massive switching. Later on, other sources including further privatization, state budget endowments, and loans should be employed. In the long run, even after prolonging the retirement age up to 65 years for both genders (which is highly probable), there will be a gap in the PAYG financial balance after 2030. However, after 2054 the PAYG will turn into surplus with majority taking a combined pension from the funded and the PAYG pillars.

PART 3: Lessons and Recommendations

Motivation: In the era of globalization it is ever easier to avoid paying social security contributions. Thus, motivation to work legally and to pay contributions is crucial for the sustainability of the pension system and the whole economy. To achieve this, the amount of pension should reflect the amount of paid contributions.

Solidarity: The motivation-oriented systems bring a danger of old-age poverty to the low income cohorts. This danger should be minimized by direct support from the social system financed from taxes. The extent of solidarity can be easily adjusted by politicians.

Transparency: The solidarity should be financed from taxes and clearly separated from the mandatory insurance and saving contributions. This enables transparent support of the weakest and creates perspective for the mandatory schemes to go voluntary and private.

[4] OECD (2004) warns: "A special issue related to the phasing-in of the 2nd pillar concerns the fiscal compensation of the main pillar from the state budget, for the diversion of PAYG contributions. These may amount to about 1% of GDP per year in the short-term and will likely increase in the following decades. As long as no agreement is reached with the European institutions for the exclusion of such compensation from current expenditures, Slovak authorities will be faced with a difficult choice between postponing or down-scaling the 2nd pillar reform, delaying convergence with Maastricht rules, or seeking yet further spending cuts."

Pensions and stability: Both PAYG and funded plans offer higher pensions under different conditions. While labor market (the change in labor force and productivity) determines pensions in the PAYG, capital market (the real rate of return on capital) is crucial for the funded system. A combination of both enables to diversify financial sources of future pensions between labor and capital markets and to increase the system's overall stability.

Transition costs: The introduction of the 2nd pillar brings huge costs of transformation. Without storing a substantial part of privatization revenues in Slovakia, the introduction of the biggest 2nd pillar in Europe would be impossible. Large portion of transition costs may be financed also from the PAYG savings created by restricting its generosity (for example by prolonging the retirement age, or imposing less generous pensions' indexation).

Demography crises: The ageing population is not a "killer" for the PAYG - the efficient though not popular answer may be prolonging the retirement age. However, the negative demography expectations have direct impact on downturn in pensions under the "ceteris paribus" PAYG. On the other hand, the funded system allows to export capital to the economy with stable or positive demography changes and to avoid negative consequences.

Automatic adjustments: Regular changes in the system should reflect the development of key economic indicators rather than ad-hoc political interferences. For example the pensions' indexation should reflect the inflation or the wage growth or both of them instead of leaving the decision to the politicians who tend to give unrealistic promises. Optimally, the indexation should only reflect the changes in the amount of raised contributions.

Administration costs: Costs of administration are everywhere higher for private than for public pension plans, and are particularly high in case of private individual accounts.

Popularity of the 2nd pillar: The number of people switching for the 2nd pillar exceeded the expectations both in Hungary and Poland. The reason was the widespread distrust in the state pension system and the willingness to save on a personal account. This argument makes the introduction of the 2nd pillar easier. However, the number of people switching raises the transition costs. Therefore, the regulation of switching process should be considered.