# Problems with Pensions Continue

By Peter Gonda, Martin Thomay*

„The die is cast!“ Pension reform as one of the financially and in terms of subject most demanding systemic changes that have been carried out from the beginning of the economic and social transformation since November 1989, starts right now. Slovakia has put the reform in motion with a delay of several years, but is still ahead of many, especially western European countries. The reform will touch almost everybody, it will require a few billion Slovak crowns and have a notable impact bringing a change in conditions in the economy and society.

In Slovakia the loss of highly set pensions is not the risk as it is in Austria, Germany or France for instance (where there is therefore the greatest aversion towards pension reform). It is its concurrence with the integration of our economy into the EU economy (EU)[1] that represents a peculiar and until now unknown risk. Due to these facts as well as considering that it is impossible to forecast the future economic development, today it is hard to say what pension reform will bring to citizens and firms. We "only" want to present to a maximum realistic extent, an independent, but at the same time clearly defined (with respect to values) and well argumented view on the government implemented pension reform and to intimate its possible consequences for citizens.

## 1. The reasons why pension reform is necessary[2]

The following substantial and mutualy interconnected problems are considered to be reasons for a thoroughgoing pension reform :

- the main goals of the pension system alone have not been met (or only partially) – it means a motivation to save for the future, functionality, effectiveness, transparency and security.

- value defects - limitation of voluntary and sufficient financial background for an individual predestined for retirement, and deepening of „dependance“ on outside sources, decisions by others and other external factors (particularly dependance on political decisions and demographic developments).

- financial and economic limits – reduction in ability to finance pensions though they have been limited and averaged out one-sidedly.

---

* Peter Gonda, Conservative Institute of M. R. Štefánik (petergonda@institute.sk), Martin Thomay, Institute for a Free Society (martin.thomay@seznam.cz).

[1] Due to the fact that Slovakia joined the EU when significantly falling behind the EU countries as regards prices (in 2002 it was around 40 % of the EU average) we presume that inflation in Slovakia will remain higher for a longer time than in the EU countries. Altogether with an expected increase in nominal interest rates (caused also by actions of the European Central Bank) it may lead to the long-term keeping of negative real interest rates and thus contribute to a decrease in the value of revenues from domestic assets and pension savings.

[2] A few reasons for this necessity, which the public is quite familiar with e.g. demographic developments, are not being paid special attention. The authors focus on, according to them, substantial – systemic – arguments for implementation of pension reform.

The main cause of the above problems (representing also reasons for the implementation of a radical pension reform) is the existence of the following systemic deformations lasting from the times of socialism :

- total dominancy of the public pillar administrated by the Social Insurance Company

- excessive weight of the mandatory principle and a too high contributary burden (28 % of the maximum benefit computational base)

- total predominance of demotivational concurrent funding (within which those who are economically active pay today´s pensions).

Such systemic deformations of the present pension system suppress personal involvement, personal responsibility and ownership rights, which together with the above mentioned sytemic problems and deformations are considered to be the key and no doubt arouse reasons for a systemic change.

The present pension system has negative impacts on both economically active people and pensioners. It demotivates the economically active by high mandatory payments to others (pensioners). Hand in hand with other welfare contributions and tax on wages of people it increases the non-wage part of labour costs for employers. This limits the official employment rate and, on the contrary, „supports“ a rise in the employment rate in the shadow economy. Generally, high fund contributions take the lion´s share of sources created in the economy.

Several decades of the existence of a demotivational set pension system (as well as the whole social system) in Slovakia have contributed to the general deformation of fundamental values. The consequence is a reliance on outside sources – especially on „omnipotent“ government and not on personal power and abilities or natural solidarity from family and other voluntary communities.

Many have not only lost the ability to provide for themselves and for their families but they have also lost interest in the public domain and voluntary solidarity. The result is the preservation from socialism of „transferred“ and lasting „dependancy“ and passivity by a considerable number of citizens.

In the long run deepening deformations have been accelerated by the aging of the population and financial problems, and therefore they really require a fundamental change in the pension system.

2. What changes does the government´s pension reform bring?

The government´s pension reform which has been triggered by legislative measures is defined in the Concept of pension reform in the SR[3] (further only „Concept“). Contrary to the present situation it presumes the current system´s change for a three pillar system. The reform, according to the Concept, is based on :

[3] Pension reform concept (with several comments) was approved by the Slovak government in April 2003 and revoked the concept of the previous government approved in 2000.

1. a change in the first pillar that will be publically administered and concurrently financed by old-age insurance contributions paid to the Social Insurance Company (the approved Law on social insurance) [4];

2. the creation of a strong second pillar (savings) that will be mandatory and capitalizing and it will accrue capital on personal accounts of savers and will be financed by old-age insurance contributions (Draft of the law on pension savings)[5];

3. an indirect support for voluntary pension schemes (Draft of the law on complementary pension saving) [6] .

Ad 1. Changes in the first pillar (a concurrent system)

Commencing January 2004 the retirement age limit will gradually rise (nine months every year) and at the end it will reach a single limit of 62 years. The formula used to calculate pensions will change and involve a higher proportion of merit. People with higher incomes will receive higher pensions and those with lower incomes will have lower pensions. To receive an old-age pension it will be necessary to have at least a 10 year long history of old-age insurance contributions. If this requirement is met but a person has not reached the retirement age limit, it will be possible to provide an early pension on condition that the pension amount, calculated according to the new formula, and counting with so called personal wage points, will reach 1,2 times the subsistence level for one main person[7]. The maximum benefit computation base will be three times the amount of the average gross wage in the economy and minimum wages will represent the minimum benefit computation base (with some exceptions).

Pensions will increase every year on the 1st of July and this increase will reflect an average inflation rate increase as well as wage increases within the economy.

Also relationships in the sickness insurance sphere are changing. An employee is entitled to receive sickness benefits from the Social Insurance Company beginning from the 11th day of temporary sick leave. The payment of sickness benefits in the first ten days of temporary sick leave was passed onto the employer.

The pensions of current and future pensioners provided from the first pillar will be financed by mandatory contributions collected by the Social Insurance Company. The deficit that will occur after a partial redirection of contributions to personal accounts will be covered by funds from the so called „Solidarity Reserve Fund“,also administrated by the Social Insurance Company. The fund will accumulate contributions as well as revenues from the privatisation of the Slovak Gas Industry.

---

[4] The Social Insurance Act is based on the act no. 413/2002 of the Code about social insurance and comes into effect on 1 January 2004.
[5] A draft of old – age pension saving act should be discussed in parliament in Decembr 2003. The act is supposed to be effective beginning from 1 January 2005, but some of its provisions will come into effect on 1 January 2004.
[6] At the time when this article was written (November 2003) a draft of complementary old-age pension saving was awaiting approval by the government. Its commencement date should be 1 January 2004.
[7] Or, if the amount of an early old-age pension is at least 0,6-multiple of the subsistence minimum amount and the insuree participates in old-age pansion saving.

Ad 2. Second (private and mandatory) pillar

Beginning in 2005, special conditions should be prepared to allow the opening of personal pension accounts in newly established special institutions – pension management companies (PMC). All those who start working after the reform begins will be obliged to save within this pillar. Economically active people now will have the option to transfer part (9%) of the total amount of fund contributions (18%) to a capitalization system within 18 months of the reform´s start. Only those savers who have not reached the age of 45 years on 1 January 2005 will be able to receive pensions from the second pillar.

The total rate of insurance contributions to the pension scheme rises from a current 28% up to 28,75% (9% pension scheme, 9% old-age pension saving, 6% disability insurance and 4,75% so called solidarity reserve fund – see table no.1). The collection of old-age saving contributions (as in the first pillar) will be done by the Social Insurance Company.

Newly established pension management companies will be obliged to create three pension funds (PF) [8].

Only commercial banks, insurance companies, traders in securities, management companies or foreign subjects with similar business might become major shareholders in these pension management companies. The Office for financial markets will perform the supervision over pension management companies. The law defines many conditional requirement activities performed by pension management companies. There are also many requirements as regards obtaining a licence, several investment related restrictions and criteria of so called cautious trade, some of them might be considered to be unnecessary.

[8] Pension trust companies will be obliged to create three pension funds with different investment strategies – conservative (only bond and financial investments), balanced (maximum 50 % shares and minimum 50 % bonds and financial investments) and growth fund (maximum 80 % shares). In the first year after having created the three funds, a company is obliged to sign up at least 50 thousand savers. The funds have no juridical subjectivity and their capital is separated from the company´s assets, so in case the company goes bankrupt or loses its licence, savers should not lose their savings. As proposed, the fixed assets for these companies reaches 300 million SKK. A pension trust company must not promote itself in any way until being given a licence.

Table No. 1: Pension scheme contribution rates (% of computation base)

| Mandatory contributions | Until 31 December 2003 | | | | From 1 January 2004 ( or 1 January 2005) [b)] | | | |
|---|---|---|---|---|---|---|---|---|
| | Employee | Employer | Together | Sole traders | Employee | Employer | Together | Sole traders |
| Pension scheme (1. pillar – public, concurrent) | 6,4 | 21,6 | 28,0 | 28,0 | 4,0 | 5,0 [a)] | 9,0 [a)] | 9,0 [a)] |
| Disability insurance (1. pillar – public, conc.) | | | | | 3,0 | 3,0 | 6,0 | 6,0 |
| Old-age pension saving (2. pillar – privat, capitalizing) | – | – | – | – | – | 9,0 [a)] | 9,0 [a)] | 9,0 [a)] |
| Solidarity reserve fund | – | – | – | – | – | 4,75 | 4,75 | 4,75 |
| Total | 6,4 | 21,6 | 28,0 | 28,0 | 7,0 | 21,75 | 28,75 | 28,75 |

Notes :

a – provided that a person participates in mandatory old-age pension saving;

b – changes in the pension scheme contribution rates resulting from the law stipulating pension saving will come into effect on 1 January 2005.

Source : Ministry of Labour, Social Affairs and Family of the SR, authors

Ad 3. Changes in voluntary (complementary) pension insurance

According to the reform draft only pension management companies i.e. a subject conducting its activities within the second pillar will be allowed to provide complementary saving services. The existing insurance companies that provide complementary pension saving services at present will be forced to undergo transformation and change into funds for complementary pension saving. Their administrators are obliged to ask for a licence to establish a pension management company. One of the conditions for trading in this sphere, which has to be met, is to sign up a minimum of 50 thousand fund subscribers. A law bill revokes today´s system of tax relief and replaces it with state „support“ (amounting to 18% of contributions, maximum 20% of average monthly wage).

3. Analysis of proposed changes: problems do not end at all

Summary

The government proposed pension reform is supposed to divide the risks connected with the provision of pensions between the labour market and financial markets, and thus limit the domination of the public pillar based on concurrent funding.

But the changes defined by the Ministry of Labour, Social Affairs and Family of the SR do not solve the fundamental problems and do not remove deformations of the current pension system in Slovakia related to the suppression of personal responsibility, motivation to save and insufficient respect towards ownership rights.

The excessive weight of the mandatory system, a high payment burden, and the fact that no space has been created for the development of optional pension schemes are the main problems of this reform. Not only the government wants to maintain the excessive weight of the manadtory system and high contribution rates, but it proposes an increase of 0,75% (see the Table No. 1).[9] Increase in the maximum computation base (which serves to calculate amount of contributions to the pension scheme) to three times the amount of the average wage will lead to further increase in (effective) contribution burden. At the same time, no preconditions for a possible contribution decrease in the future have been created. Despite a moderate decrease in other social contribution rates (unemployment and sickness insurance) this pension system will help to maintain high labour costs for employers and limit the accumulation of sources that are necessary for investments or pension funding in Slovak economy.

Assessment of the changes proposed within the first pillar

The new law about social insurance brings some new positive features in comparison with today´s regulations. It applies mainly to an increase in importance of principle of merit implementation which means that the pension amount will depend more on the wage amount (through so called wage points) as well as meaning a more suitable way of adjusting pensions, (valorization), the character of which will limit political influences.

But the new law does not represent a more fundamental change when compared with the regulation nr. 413/2002 of the Code on social insurance approved in May 2002.

Therefore it is possible to reproach the new law with the following :

- There are no more conceptional changes which would lead to the creation of a system granting only basic standards and funded e.g. from taxes or virtual individual accounts (NDC model) [10]. despite the fact that the NDC model could by

[9] This is – as regards rates – an even worse proposal than that one included in a concept submitted by the Ministry of Labour in the previous term (minister Magvaši) which promoted only a slight decrease in the contributions to the pension scheme from 28 to 27,5 %.

[10] NDC (Notional Defined Contribution) system – a concurrently funded system with virtual personal accounts. Contributions to this system are accumulated with a set interest rate. The pension amount on the day of retirement is then calculated as a ratio of accumulated funds and life expectancy.
Collected contributions are also used to finance pensions of current pensioners (as it is in a classic PAYG system). On the other hand, the principle of individual accounts creates a desirable link between the contributions or period of contribution payments and a pension amount within the system. Such a system features built-in stabilising mechanisms, the retirement age limit is

implementation of the merit principle have a more positive influence on the labour market.

- The pension amount does not sufficiently reflect the amount of contributions, though it does it on a larger scale then today´s pensions (paying different amounts of contributions in different periods, the people with the same incomes, who will receive the same amount of pension at the end, may contribute to the system with significantly different amounts).

- An insufficient rise in retirement age limit only up to 62 years of age – a unique opportunity to promote a further rise of the age limit and to propose e.g. its rise up to 65 years when there was practically no hostility to this option, was ignored.

- no systemic solution for providing of disability pension and transfer benefits (for widows, widowers and orphans), because the reform, except for having separated them from old-age pensions, does not consider any more notable change.

- the reform does not represent any universal system, old-age pensions in the so called power departments of the state remain outside the reformed system which means the preservation of unproportionally generous pensions for those groups of civil servants to the disadvantage of other tax payers.

Assessment of proposed changes in the second (capitalizing) pillar.

Implementation of the manadatory system of pension saving in its present form brings several significant problems and risks :

- the proposal allowing the Social Insurance Company to collect contributions to old-age pension saving funds, taking into account that the company is not administeratively capable of coping with it today, is hard to substantiate and is very risky.

- we may expect overpricing of personal account administration, especially when it comes to marketing expenses (particularly intermediation of new contracts) – a result of efforts to appear to be different in a limited competitive environment. Rich experience with functioning of similar systems in other countries proves this.

- due to the proposed investment restrictions (e.g. obligation to invest a minimum 50% of the fund assets into securities in Slovakia) we cannot expect that the yields of invested pension savings will be sufficient.

- also the obligation to maintain the value of pension fund assets above 80% of the average value of competing funds´ assets will lead to higher costs and lower returns.

- transfer of pension savings onto other family members is not clearly defined ( the pension saving contract contains only the name of a person who will

automatically adjusted to demographic development and the system has a more positive influence on the functioning of the labour market than a classic, by benefit distribution defined, concurrent system. The NDC system was introduced for instance in Latvia, Poland and Sweden.

receive savings after the demise of the saver, the rest of the accounted amount is not an object of inheritance proceedings).

Thus the government instead of decreasing pension scheme rates introduces a costly mandatory capitalization system under Slovak conditions (the second pillar). Due to expected development in the labour market, negative real interest rates (connected with the accession of Slovakia to the EU), higher costs related to a new capitalization system setting, and the necessity to finance extensive transformation costs, the introduction of such a mandatory capitalization system might cause a lower level of pensions when compared with wages than today, yet a lower level if compared with an alternative proposal offering suitable adjustment of today´s concurrent system.

It seems that during the approval process the government underestimated the need to find additional sources of funding for „transformation costs", i.e. funding for deficits within the first concurrent pillar after transferring part of the contributions to the capitalization pillar. The government believes that not more than 50% of today´s insurees will save in private funds and does not consider any alternative scenario of funding for concurrent system deficits in case more people decide to save in the second pillar. It is more than obvious that the start of the reform will be followed by a massive promotion campaign of pension management companies, so the assumption that more people will decide to save within the second pillar is more than real. This could cause problems for public finance and thus represent the risk of a tax and contribution increase which also means an increase in public debt. Any other funding for deficits should be strictly bound to privatization revenues and savings (if there are any) in public expenditure.

Assessment of changes in complementary pension insurance

Neither the excessive weight of pension system´s mandatory pillars nor the proposal of changes in the complementary pension insurance will contribute to the creation of better conditions for facultative insurance.

The reasons are the following :

– limitation of opportunity to establish and manage a complementary pension saving fund only to pension management companies, represents a significant barrier for entering the system and it will have a negative competitiveinfluence in the environment

– introduction of state insurance premium and cancellation of the current system of tax relief (which is a relatively more advantageous form of saving support i.e. without proprietary rights violation) brings a factor of forced redistribution into a facultative system

– the fact that a pension from a complementary pension saving system is conditioned by awarding a pension from a mandatory pension scheme. This stipulation is absolutely illogical in a facultative system.

Only a consistent (though gradual) change in the current system into a system of dominant private and facultative funding is a real reform. Facultative relations represent a broad base of options of how to ensure a good life in old age or if disabled, or after having lost a provider, whether it is through pension saving, life insurance (or their combination), business or through a facultative solidarity fund. Even today the financial instruments allowing adequate security in old age with an acceptable risk are available.

Personal reponsibility of an individual for his or her future financial security should not therefore be forced.

On the contrary, the dominat present concurrent public funding should change into a complementary pillar meeting the breadline. The pillar should be funded from taxes, though it should grant the claims of all the current pensioners in the transitional period by also using mandatory public contributions if necessary (e.g within a system of so called virtual accounts). Later, it should be tailored to the objective and proved needs of individuals only.

All this could be part of systemic changes in society leading to a change (reduction) in the government´s tasks and in extent of mandatory social solidarity in Slovakia.

Peter Gonda is an economic analyst for the Conservative Institute of M. R. Štefánik. Martin Thomay works at the Institute for a Free Society.

The article was published in the magazine OS in 2003. It is available at http://www.institute.sk.