PENSION REFORM

PART 1

Ing. Ivan Barri, Financial Market Authority

We live at the time where almost everywhere in Europe the population is ageing and the average age of pensioners is rising. Pensions are therefore being paid out to an ever greater percentage of people. Trust in the pay-as-you-go system of pensions paid out by the state in many countries evaporated long ago and reform is urgently needed. The phrase "pension reform" has become one of the most frequently used in 2004 in Slovakia. Reforming the pension system is though the most difficult reform of all. In comparison with other reforms its objective is to change the functioning of a complicated, ossified and extensive pension system. Each pension reform must count on high transformation costs. Health and education are equally complicated mechanisms, neither of these however have created such high levels of debt for future generations.

What is the history of pension systems and how did people perceive the need for pension security?

The beginnings of a pension system can be found back in Ancient Rome, when the first real pensions were paid to retired Roman soldiers. This system worked on the principle of regular contributions from the soldiers' pay, which soldiers deposited during their active service into a fund. Pensions were then paid out from it to soldiers who had completed their service, whether due to age or injury. Pensions were similarly paid also to the surviving relatives of a soldier in the case of his death in service. It is interesting that the accumulated contributions of members served sometimes also for investment - they were used for example for interest-bearing loans, or for purchasing slaves.

In the medieval society, which was marked by religiosity and the strength of the family's role, the subject of pension security did not enter into the agenda. No regular pension system existed and people who did not have family were no longer able to support themselves and were dependent on charity and begging. The first pension scheme appeared in the 1770's in England. It was not however nationwide, but concerned only one employee group - retired naval officers. There were here though already the first modern elements of a pension system. The first of these was the setting of a term of the number of years worked, following which a pension could be paid out, the retirement age however was not fixed. Another modern hallmark of the scheme was its setting of the sum of the pension paid out fixed at 100% of the salary.

In the 18th century the payment of pensions to state employees was becoming increasingly common, as were mandatory contributions to pension funds. The state became an important initiator in creating pension systems only really at the turn of the 20th century. Mandatory employee and employer contribution schemes were set up, creating state pension systems, and the attitude of society towards pensions changed, too. Pension security became a common feature of the state system.

At present there now exist a large number of pension schemes in all corners of the world; nevertheless it may be ventured that they have many features in common. First of all, modern pension systems should fulfil the criterion of long-term sustainability. Clients should be guaranteed an average level of pensions and security of their investments. Emphasis should also be placed on the individual responsibility of a person for their own future and people should be weaned off implicit reliance on the state pension.

Today however no two countries exist having identical pension systems and a significant degree of difference between them can be seen also by the fact that the field of pension security has so far never become a subject of European harmonisation. Sweden or Denmark, countries generally perceived as having a high degree of redistribution, have pension systems completely different from other European countries. Sweden operates something akin to a second pillar, in which people can direct a part of their mandatory contributions into hundreds of different unit trusts and thereby save for their pension. Other European countries, for example Germany, Austria or France have only pay-as-you-go systems, which through their over-generosity are on the verge

of collapse. The announcement of even minimal changes to parameters brought about great discontent among citizens. At the opposite end of the spectrum we find Great Britain, whose state system of mandatory pension security provides only a minimal pension and people long ago had to get used to saving for their old age either in employee pension schemes or by means of life insurance policies.

Pension system reform

Pension system reform can be approached in various ways. Generally we can identify four basic types of pension reform of state pay-as-you-go systems from the manner in which these reforms have been implemented around the world:

• **parametric reform** – this is the simplest way by which the state pay-as-you-go system can be reformed. It is however at first glance apparent that the word reform is used incorrectly here, because a parametric adjustment to the system does not bring about its change, but merely postpones problems for a couple of years. It does not resolve the essence of the problems, instead merely mitigates the manifestations of the crisis in the pay-as-you-go system. The adverse course is unchanged by the parametric adjustments; problems are solved only for the short term, sufficing only until the next electoral cycle, but it will again later be necessary to increase contributions and extend the retirement age. An accompanying feature of parametric adjustments, where they are made as the only form of "change", is a reduction in the level of pension security and subsequent increase in the cost of real pension reform in the future. Through making parametric changes politicians try to reduce the current deficit in the pension system - by increasing the retirement age, raising mandatory contributions - though in no way does this resolve the underlying problem.

• **introduction of a notional defined contribution system** – even here this concerns only the adjustment of the pay-as-you-go system, the sole advantage of which is the introduction of transparency. The introduction of a notional defined contribution essentially means only that that each participant in the system gets once a year a statement from the central register – the Sociálna poisťovňa insurance company in Slovakia – in which there is recorded how much money the person has been contributed to the system so far. This system however continues to work in the same manner as before, no reserves are created in it and in no way are the accumulated problems and implicit debt in the system solved; it merely continues in the pay-as-you-go payment of pensions, while outwardly simulating saving. Following retirement, while the amount paid is calculated according to how much money the person has invested in the system, it will nevertheless again be paid out only from the contributions of working people. The introduction of virtual accounts then does not remove the underlying problem. Statements from virtual accounts are futile if there is still not enough money in the system. A pension scheme reformed in this way is still reminiscent of a Ponzi scheme.

• **the three- or more pillar scheme** – comprises three parts: a mandatory pay-as-you-go pillar administered by the state, a mandatory saving pillar administered by private companies and voluntary saving schemes. The **first pillar** in this case can be understood in two ways. In the first instance redistribution forced by the system continues and should provide the minimum necessary degree of protection against poverty in old age. This means that it is wholly collective and only those people who have not managed during their active lifetime to save sufficient money in personal accounts, whether mandatory or voluntary will have a claim to a pension from this system. The payment of pension benefits from this pillar thus represents merely protection against poverty and in some countries includes, for example, means testing. This is a variant of the social safety net, by which the state guarantees a minimum social security for everyone who actually needs it. The costs of a first pillar constructed in this fashion are therefore low, enabling a reduction either in mandatory contributions or the transfer of most of them to the second pillar. The **second option** in setting up the function of the first pillar is the provision of wage compensation for every person. This function brings with it a more expensive first pillar which is more inclined to collapse into financial crisis and which at the same time more slowly redresses the hidden debt inherent in the pension system. Whereas in the case of the first method the merit principle is given little significance, in the case of the second method its use is more just, but to a certain degree oppugns the social solidarity that should otherwise ensue from the first (state-managed) pillar.

The **second pillar** also represents mandatory contributions, which however do not flow into a pay-as-you-go system, but to employee's real personal accounts, operated by a private company. The essence of the second pillar thus lies fully in the merit principle, where the money invested in personal pension accounts, similarly as in the case of collective investment, is appreciated on the capital markets. Through the transfer of a part of the pension system to the private sector the degree of political risk is significantly

reduced and the changeover to personal responsibility for one's own pension is made. This always however depends on what the actual regulation of the second pillar is, what share of mandatory contributions to it is made and how the ownership right of savers is ensured. The stronger the role becomes of the second pillar in the pension system over the first following reform, the greater the benefits of the whole reform, primarily for the indebtedness of the whole system.

The **third pillar** comprises voluntary pension saving schemes, and which take various forms in different countries, in general however various forms of employee funds prevail, based on various tax advantages and relief measures. This can also concern various supplementary saving schemes, whether by means of banks, collective investment or life insurance.

Complete privatisation of the pension system – this approach to pension reform represents the complete cancellation of the state pay-as-you-go system and its replacement by mandatory saving in pension accounts administered by private-sector fund management companies. This saving is naturally supplemented by the option of saving in voluntary pension schemes. This type of reform was introduced for the first time in Chile 24 years ago.

Pension system reform should reflect two basic principles:

• a transition to personal responsibility and voluntariness – meaning the predefinition of the objectives of pension security (primarily of the state pay-as-you-go pillar) so that people are motivated to take care of their pension themselves. The state pension from the mandatory system should then correspond to (low) contributions and to the lowest acceptable standard of living (at the level of the living minimum) and everything else should be based on the principle of voluntariness.

• the separation of solidarity and merit – if the decision is taken that the state pension system should provide not only a minimal degree of income compensation, but at the same time provide also wage compensation, then it is important that each person knows how much money he/she is contributing into the solidarity fund for other people's pensions and how much to their own account.

Pension reform in Slovakia

Any implementation of pension reform depends on the specific conditions of the country in which the new model is being introduced. Primarily this concerns the economic conditions and political environment, but also adherence to traditions in the field of pension security. The realisation of pension reform is not necessarily connected with the introduction of a capitalisation system. In its implementing, the fact cannot be ignored that a pay-as-you-go system needs to be regulated so that it is financially stable and does not give preference to one group of the working population to the detriment of another group. In launching pension reform in Slovakia its basic features were announced in advance in the government's manifesto. They are based on the experience from many countries, from their successes and problems and from what has been tried and tested so far.

The objectives of reform and their realisation have received support also from representatives of the World Bank and the OECD. Slovakia, thanks in part to this has gained for itself a strong reformist image. The greatest inspiration for pension reform has been the Chilean model of pension security. To term the Slovak model of pension reform as Chilean would though be definitely wrong, since, among others, there are many cardinal differences. Firstly, Slovakia has retained the first pay-as-you-go financed pillar. Slovak reform of pension security implemented a three pillar system with a strong first pillar.

The first pillar in the sense of continuing the original pension system has remained for working people who decided not to make the changeover to the capitalisation pillar as the only mandatory component of pension security. This pillar has undergone several parametric changes and the merit principle was introduced into it by means of creating notional personal accounts.

A radical change in the whole understanding of pension security in Slovakia was the establishment of a capitalisation second pillar. In this system of old-age pension saving, which has the nature of a compulsory defined contribution system, will be invested the contributions of the active population in the amount of 9% of the assessment base. These financial resources accumulated in pension funds will be placed by pension fund management companies on the financial markets in investment instruments. It may be expected that over the long term, assets totalling more than 50% of Slovakia's GDP will be placed in old-age pension saving pension funds. It may also be expected that the introduction of a system of old-age pension saving will induce positive externalities in the form of a recovery in the Slovak capital market.

Participation in this pillar will be voluntary for all working persons. For persons entering the labour market for the first time following the launching of the capitalisation pillar entry to the capitalisation pillar

will be mandatory. Employees of the forces (police and soldiers) are to remain outside the capitalisation pillar.

The establishment of the second pillar has been communicated most by the pension fund management companies. These are joint-stock companies with minimum registered capital of SKK 300 million, having a registered office in the Slovak Republic and whose business is exclusively the creation and administration of pension funds. A pension fund management company must be licensed to operate. In contrast to other joint-stock companies, the registered capital must be fully paid-up in cash deposits in the amount it was subscribed. A further condition is the attainment of at least 50 000 savers within the period of 18 months from the commencement of creating pension funds. A pension fund management company is obliged to create three pension funds, differing in terms of their strategy, name, the portfolio created and the degree of risk inherent in the appreciation of assets. The registration and management of assets in a pension fund are separated from the registration and management of assets in the pension fund management company.

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