

# PENSION REFORM IN SLOVAKIA

## SUMMARY: MAIN PRINCIPLES AND OBJECTIVES

At the beginning of the election period the government made a promise to reform the pension system. The goals of the new scheme were:

- ensure long-term sustainability of public finances, which is threatened by demographic developments
- strengthen the merit principle (future pension should reflect the amount of paid contributions)
- increase the importance of voluntary pension schemes

To achieve these targets, a three-pillar system was created. The first pillar is the old but reformed pay-as-you-go system, the (new) second fully funded pillar is based on the principle of savings and the third one consists of various forms voluntary pension and life insurances.

## PAY-AS-YOU-GO (FIRST) PILLAR

The reform eliminated from the system factors that prevented pay-offs of any personal initiative. The new system increased the degree of merit-based rewarding since it made a **direct link between the amount of contributions and pension benefits**. Length of the service life and wage level are import parameters to calculate pensions. Replacement rate is expected around 50% (pensions are not taxed). Solidarity in the system was restricted to support of individuals who for various reasons were unable to accumulate fund that would be higher than 1.2-fold of the subsistence minimum.

An important part of the reform was a **rise of statutory retirement age** from initial 60 years for men and 53-57 for women (depending on the number of children) to 62 years for both genders. This will be done gradually at rate of 9 months a year. Earlier retirement is possible if the pension benefit reaches at least 120% of the subsistence minimum. Moreover, it is sanctioned by pension reduction by 6% per year. Those who postpone their retirement receive a bonus of 6% a year.

Unlike before, in the new system, pensions will be indexed every year on 1 July by an index that will **average out the annual inflation and an increase of the average nominal wage** in the economy. The former indexation was based on pure political decisions.

The Law **changed also the system of pension contributions**. The new scheme separates financial flows to (i) old-age, (ii) disability, and (iii) 'solidarity' fund. The assets from last one will be used for possible liabilities arising in the first and second pillar. The overall rate of pension insurance premiums amounts to 28.75% of the assessment basis (gross wage). Employers and employees pay 21.75% and 7%, respectively. A more detailed overview is provided in the table below. Employee's premiums are reduced by 0.5% for each child. The maximum assessment basis was set to three-fold of the average wage in the economy. The minimum assessment basis was set by the minimum wage.

## FULLY-FUNDED (SECOND) PILLAR

The second pillar was set up by the Law on Old-Age Pension Savings which came into force in January 2005. All citizens in productive age will have to decide within one and half years (January 2005 – June 2006) whether to begin saving on their own pension accounts or to stay in the reformed PAYG pillar. Once in the second pillar, they can not opt out. Saving in the fully funded pillar will be compulsory for the newcomers on the labor market. The pillar will be financed by **pension contributions of 9% of the gross wage** and which is the same in the first pillar. Old-age pensions will be paid out to those who have saved for at least 10 years.

The citizen will have an option to choose one of the PAMCs and switch it costless once a year. PAMCs will have an obligation to create three types of funds in which the saver will be able to invest:

- conservative fund – low-risk and -return investments into bonds;
- balanced fund – medium-risk and -return investments into bonds (at least 50% of portfolio) and stocks;
- growth fund – high-risk and -return investments into primarily stocks (up to 80% of portfolio).

To avoid unexpected fluctuations of funds value just before retirement, the accumulated assets have to be shifted to balanced or conservative fund at least 15 years before the legal pension age. Seven years before the statutory pension leave all the assets have to be placed in conservative fund. Any fraud or malefaction concerning the funds should be prevented by strict supervision of Financial Market Authority. Should fraud, nevertheless occur, the state will guarantee for the savings to full extent, however, only up to 50% of the solidarity fund assets. The state will not guarantee any specific performance of the funds but sets certain criteria concerning the minimal rate of return.

Premiapaaid to the second pillar will be collected by SIA, which after deducting 0.3% fee will transfer the money to PAMCs. Pension companies will be able to charge a fee of 1% from the incoming insurance. In addition, they may also charge an asset management fee of 0.07% of the total monthly asset value.

<b>Pension insurance contributions (% of gross wages)</b>					
	<b>2002</b>	<b>2003</b>	<b>2004F</b>	<b>2005F</b>	<b>2006F</b>
<b>Paid by employer</b>	<b>21.60</b>	<b>21.60</b>	<b>21.75</b>	<b>21.75</b>	<b>21.75</b>
Pension insurance	21.60	21.60	19.00	17.00	17.00
- old age insurance*	–	–	16.00	14.00	14.00
- disability insurance	–	–	3.00	3.00	3.00
Reserve fund	–	–	2.75	4.75	4.75
<b>Paid by employee</b>	<b>6.40</b>	<b>6.40</b>	<b>7.00</b>	<b>7.00</b>	<b>7.00</b>
Pension insurance	6.40	6.40	7.00	7.00	7.00
- old age insurance	–	–	4.00	4.00	4.00
- disability insurance	–	–	3.00	3.00	3.00

\* Employer will pay 5% to PAYG and 9% to the second pillar on behalf of the employee.

Source: Ministry of Finance

### THIRD PILLAR

The Law on Supplementary Pension Savings addresses previous deficiencies in the market for supplementary pension schemes. Tax advantages are retained and broadened. Income tax deduction can go up to 10% of the yearly income for employees. The maximum deduction is set on SKK 12,000. The tax will have to be paid additionally, however, if deposited money is withdrawn prematurely, that is, before 10 years of saving, or before reaching the age of 55. In case of pension allowances that will be paid out from the third pillar only realized yields will be taxed at rate of 19%. In the past the whole allowance was taxed at rate of 10%.

The Law further broadens tax allowances also to other products, such as, life insurance, mutual funds investments, and long-term deposits in banks or insurance companies. Employers will be able to add such contributions to costs and deduct them from taxes up to 3%.

### PENSION REFORM AND PUBLIC FINANCE

The undertaken pension reform had as its main goal to ensure the long-term sustainability of public finances. As the result of reform, the implicit debt should decrease from 400% of GDP in 2003 to a level of 170% of GDP in 2080.

Reduction of the implicit debt will show off in worsened balance of the first pillar. Transformation costs stem from diverting a part of pension contributions to the capitalization pillar causing thus reduction of SIA revenues while retaining the same liabilities. Transition costs will depend on:

- the number of people joining the second pillar
- time when they join
- what income groups enter the capitalization pillar.

The income shortfall of SIA will grow from 0.4% of GDP in 2005 to 1.3% in 2014. Worsened balance caused by implementation of the second pillar will be already visible in the near future.

Positive effects of the capitalization pillar, on the other hand, will be observable only in the long-term. As the graph below shows, due to implementation of the second pillar the overall expenditures on pensions will decrease in the future. Moreover, the large deficits in 2050s will be gradually reduced and SIA should reach positive balance position in 2070s. The deficits will be initially financed from privatization revenues, which to this date amount to about SKK 66 bn. Later financing of transition costs will be assured by revenues from additional privatization projects. In case of insufficient resources, the state will use other tools to finance the costs, such as, increasing of the country debt, increasing the taxes or reducing the governmental expenditures, or prolonging the retirement age. In Slovakia, the transition costs should not increase the deficit of public finances by more than 1% of GDP a year, in order to ensure the compliance with Maastricht convergence criteria (fiscal deficit should be below 3% of GDP) that are required for Slovakia's entry to the Euro zone in 2009.

The pension reform was inevitable and its postponement would put a bigger burden on future generations. Although the current pension system may need some additional modifications, as a whole it forms a basis for the long-term sustainability of public finances. In the long-term perspective there is an additional benefit of the reform, namely, a possibility for further reduction of mandatory premiums. This may improve the business environment in Slovakia and consequently it may contribute to employment and economic growth.