

SLOVAK REPUBLIC

Technical Notes

On the Pension System in the Slovak Republic: 2008 updates



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1. Introduction

The purpose of these notes is to provide update information of the pension system in Slovak Republic and to identify the areas of ILO technical cooperation in pension reform as a follow up the technical mission undertaken in 2007¹ at the request of the Minister of Labour, Social Affairs and Family of the Slovak Republic.

These notes have been prepared by Kenichi Hirose, Senior Specialist in Social Security of ILO Sub-regional Office for Central and Eastern Europe, based on the findings of his mission to Bratislava from 21 to 25 April 2008. The author is grateful to all the people consulted during his mission. Particular mention must be made of the support given by Mr. Juraj Džupa, Director of the Department of EU Affairs and International Cooperation, Ministry of Labour, Social Affairs and Family of the Slovak Republic.

2. Pension reform in 2003-2004

In 2004, the pension system in the Slovak Republic went through a major structural reform. The Slovak pension system has been reorganized into the combination of the traditional pay-as-you-go pension system (Pillar I, Act 461/2003) and a new mandatory privately-managed pension savings system (Pillar II, Act 43/2004) which became operational in 2005.

One challenge facing the current Slovak pension system is the problem of financing considerable transition costs. Out of a total 18% of contribution rates, 9% is diverted to the Pillar II system, thus only the remaining 9% is retained to cover the expenditure of the Pillar I system. As shown in the following table, the magnitude of the contribution diverted to the Pillar II pension funds in Slovak Republic is larger than that of any other Central and Eastern European countries that implemented a similar multi-pillar pension reform. In addition, out of total 2.6 million workers 1.5 million workers have chosen to join the Pillar II system, which largely exceeds the initial anticipation of 0.3 to 0.8 million workers. This is partly due to very active promotion of private pension fund companies. It is reported that certain number of workers who are close to the retirement age (and thus would not have time to build up sufficient savings in Pillar II) participated in the Pillar II. Unlike other Central European countries, no age limit was set for the entry into Pillar II.

Contribution rates for old-age benefits in selected Central and Eastern European countries

(in percent)

Country	Total	Pillar I	Pillar II	Share of Pillar II contribution rate
Romania	29	26.5	2.5	9%
Latvia	20	18	2	10%
Bulgaria	23	19	4	17%
Hungary	29.5	21.5	8	27%
Croatia	15	10	5	33%
Macedonia	21.2	13.78	7.42	35%
Poland	19.52	12.22	7.3	37%
Slovak Republic	18	9	9	50%

¹ ILO, "Slovakia: A technical note to the Government on the preliminary assessment of the pension reform process in Slovakia", August 2007.

While the revenue to the fund has decreased due to the diversion of contributions, the current pensioners continue to receive pensions. Hence, the balance in the social pension (Pillar I) fund is expected to be in deficit until around 2030. From 2005 to 2010, even if the surpluses in other branches (sickness, employment injury, unemployment) are used to fill the deficit, the balance of the social security system as a whole is expected to have a deficit in the order of SKK 20 to 30 billion annually.

3. Amendments in 2007-2008

The government has recently implemented several amendments to address the short-term problems.

First, for the period from January to June 2008, workers are allowed to move between Pillar I and Pillar II pension systems. By the end of June, about 105 thousand workers left the Pillar II. This result exceeds the initial estimations. The Ministry of Labour, Social Affairs and Family estimated that about 30 thousand would leave Pillar II, while Ministry of Finance estimated 70 thousand. Most of these workers are older than 40 years and earn less than SKK 100,000 a year. On the other hand, about 21 thousand workers, most of whom are younger than 30 years of age, joined the Pillar II. Thus, the percentage of net number of workers who left Pillar II is about 3%.

Second, the qualifying period for pensions has been extended from 10 years to 15 years for both Pillar I and Pillar II. Since the Pillar II started in 2005, this implies that workers who were older than 47 years of age in 2005 cannot receive pensions. Ministry of Labour, Social Affairs and Family estimates that about 600 thousand workers may not reach 15 years of contribution. In terms of number of workers, this measure has a much more significant impact than the previous measure.

Third, the ceiling of the contributory wage has been increased from 3 times the average wage to 4 times of that. This increase in the ceiling was suggested by the Ministry of Finance. This will have an immediate effect in increase the contribution revenues to the fund if this does not affect the compliance to the contributory wage reporting.

Fourth, measures to contain the increase in the benefit in payment have been implemented. The indexation of pension is made at the average of price inflation and the wage increase (the so-called Swiss indexation). The qualifying conditions for early retirement pension have been tightened.

Fifth, for disabled contributing workers, the State will subsidise their contributions only if they remain in Pillar I.

Sixth, women who have children less than 6 years of age can voluntarily join Pillar II.

Seventh, in end 2007, the government approved a Bill to pay Christmas allowance for 1,051,936 pensioners with low level of pensions. This allowance was between SKK 1,500 and SKK 2,000 per pensioner depending on the level of pensions and it was paid to pensioners receiving less than SKK 11,257 per month. The total expenditure for this allowance amounted to SKK 1.7 billion.

4. Information leaflet of the government

In April 2008, the government distributed an information leaflet to all workers. It contains a message of the Minister of Labour, Social Affairs and Family, explaining the new pension system and the open period for reconsideration and clarifying some misconception of the new system. It also contains the following table comparing the expected benefits under the two systems by different age².

Comparison of the expected old-age benefits by different generations

Age	40	35	25	
Year of retirement (at age 62)	2030	2035	2045	
Number of years of contributions to Pillar I	44	44	44	
Number of years of contributions to Pillar II	22	27	37	
Expected amount of benefits (SKK)	Pillar I only	5,275,582	6,115,845	8,219,184
	Pillar I and II	4,062,420	5,193,952	8,486,265
Difference (SKK)	- 1,213,162	- 921,893	+ 267,081	

Source: Ministry of Labour, Social Affairs and Family

Note: Assumed current gross salary SKK 25,000.

Salary increase 3% per annum and interest rate 5% per annum have been assumed.

A key message of this result is that under these assumptions workers older than 35 years of age would be better off if they stay in Pillar I. At this stage, the effect of the information leaflet on the behaviour of the workers is not fully known. However, it is reported that the dissemination of the government leaflet stimulated the discussions of general public, media and also several pension funds about the advantages and disadvantages of Pillar I and II pensions.

5. Options to restore the financial balance

In general, the financial deficit can be eliminated by increasing the revenue or by reducing the expenditure or combination of both.

On the strengthening the income side, possible measures include (i) increase in the contribution rate, (ii) increase in other source of income, and (iii) improvement of the collection.

The following observations are made:

- The total social security contribution rate is already at a high level at 48.6%. Further increase in social security contribution will result in an increase in labour costs, which in turn would affect the country's competitiveness.
- In the absence of substantial reserves, resources from other sources are also limited. In fact, the surpluses in other benefit branches (sickness, employment injury, unemployment) are used to cover the current pension deficit. Without such a cross subsidization, these surpluses could be used to improve these benefits.
- As Slovak Republic is pursuing the accession to the Euro zone in 2009, it should meet the Maastricht Convergence Criteria, which requires the public deficit to be less than 3% of GDP and the total public debt to be less than 60% of GDP. Although the current level of public debt of the

² The Ministry of Labour, Social Affairs and Family has also estimated internal rates of return of the Pillar II scheme.

Slovak Republic is relatively low at 30.6% of GDP in 2007, the financial authority is cautious to any increase in the public borrowing in view of the compliance to the EU criteria.

- The current government takes rather deliberate stance regarding the privatization of state-owned enterprises. After the revenue from the privatization of Gas industry is completely used by the first quarter of 2009, there will be no additional resources allocated to pension from privatization of state-owned enterprises.
- One solution for financing the transition cost without increasing the total contribution rate is to adjust the division of contribution rates between Pillar I and Pillar II. In fact, a proposal considered in 2007 was to change this division from 9:9 to 12:6. This proposal was supported by the trade unions, however, it faced strong objections from private pension funds and some contributors.
- One potential area of efficiency improvement is contribution collection. Improvement in compliance is a legitimate requirement. However, this has to be conducted without significantly increasing the administrative costs. In addition, it is estimated that around 300 thousand self-employed workers are not contributing to social security schemes. It is important that efforts should be made to extend the scheme coverage to currently unprotected workers.

On the expenditure side, possible cost containment measures include (i) change in indexation method, (ii) reduction of pension level, (iii) increase in retirement age, (iv) review the generous pensions.

- The Slovak Republic has already introduced the so-called Swiss indexation method adjusting pensions in line with the average of increases in price index and in wage index. An alternative, supported by the Ministry of Finance, is to index pensions in line with price increase only. In general, changes in indexation can have a significant financial impact in the long-term. At the same time, the basic minimum level should be protected as it is crucial for the prevention of the poverty in old-age.
- Under the Pillar I pension formula in the current Pension Act, one contribution year (paid at full 18%) yields about 1.25% of accrual rate in terms of revaluated average wage (based on point system). Thus the benefit rate for an average retired worker with 40 years contribution would be around 50%. This benefit level is almost equivalent to the minimum level prescribed in ILO Social Security Minimum Standard Convention No.102 (Slovak Republic has ratified Convention 102 since 1993). Thus, uniform reduction of the pension formula may result in failure to meet the minimum pension standards.
- The retirement age is currently set at 62 years of age (the retirement age for women is in the process of gradual extension to 62 by 2015). Raising the retirement age, for instance to 65 years, is one option to cope with the extension of life after retirement due to increasing life expectancy. In order to keep the growth of the national economy in the anticipated decline in the working age population, utilizing the workforce of older workers is a possible option. At the same time, labour market and pension system should provide flexible retirement by coordinated labour market policy and social security policy.
- From the point of view of equity, unreasonable privilege in terms of pension amount or early retirement should be limited. This will also lead to a closer link between contribution and benefits.

6. Prospects of the Social Insurance Agency fund, 2007-2011

The budget of the Social Insurance Agency for 2008, prepared by the Ministry of Labour, Social Affairs and Family and the Social Insurance Agency, includes the actual achievement of the SIA fund in 2007, the budget for 2008 as well as the three-year forecast covering the period 2009-2011.

In 2007, the balance in the old-age benefits branch of the Social Insurance Agency fund had a deficit amounting to SKK 28.7 billion. A large part of this deficit is due to the fact that SKK 22.6 billion was transferred to private pension funds which manage Pillar II savings system. In that year, the government transferred SKK 20.2 billion to the SIA. The remaining deficit was covered by the net surplus of other benefit branches. As a result, the total balance of the Social Insurance Agency recorded a surplus of SKK 2.1 billion.

In the SIA budget for 2008, the government allocated SKK 17.1 billion for the pension transition cost. In the three-year forecast, the government has indicated SKK 21.8 billion in 2009, SKK 22.9 billion in 2010, and SKK 34.1 billion in 2011. At this stage, it is not clear whether this implies that the government has secured such a source. It should be noted that from the funds of the privatization of the gas industry about SKK 70 billion was earmarked to finance the pension transition costs. However, this fund is estimated to be fully used by the first quarter of 2009. Therefore, for the government to keep its budgetary commitments in 2009 and after, it needs to find funds from other sources.

7. Long-term sustainability of the pension system in face of the ageing population

The present Slovak pension system also involves a concern with long-term sustainability in the context of severe population ageing which will peak in around 2050. According to the 2006 United Nations population projection (medium fertility variant), the demographic old-age support ratio (the ratio of population aged 65 and over to the population aged 20-64), currently 18.3% in 2005, is estimated to increase rapidly to 25.4% by 2020, 33.3% by 2030, 40.5% by 2040, and 55.3% by 2050. One main reason for the ageing is the sharp and rapid decline in the fertility rates in the 1990s, followed by a period of relatively high fertility rates in the 1980s. A long-term forecast indicates that a deficit of the Social Insurance Agency at the level of 1.0%-1.5% of GDP is expected by 2035 but thereafter the size of the deficit is projected to increase to the level at about 2.0%-2.5% of GDP by 2055.

Although the current policy discussion focuses on the problem with the transition costs, attention should also be given to the long-term sustainability of the system. For the current working generations, the concern with the potential pension crisis in the future creates non-confidence in the government to keep the promised pensions. In an intergenerational transfer mechanism such as a pension scheme, its sustainability critically depends on whether the working generation agree to pay contributions for the elderly generation.

8. Benefit design of the Pillar II

Section 29 of the Act on pension savings (Law 43/2004) concerns the benefit of Pillar II. The scope of the benefit from pension savings covers (1) old-age pension, (2) early old-age pension, and (3) survivors' pension. Old-age and early old-age pensions can be paid in the form of (a) life annuity or (b) combination of life annuity with programmed withdrawal. Survivors' pensions are paid to the surviving spouse (at the rate of 60%) and orphans (30% each) in the form of annuity.

The final balance in the individual pension savings account will be converted into annuities by dividing the balance by an actuarially defined annuity factor. The annuity factor depends on two key parameters, namely the assumed interest rate and the assumed life tables. In this regard, the Annex A of the Act

only stipulates that the unisex mortality rates approved by the Financial Market Authority should be used but it does not specify such table or the interest rate.

For the illustration purposes, the following table presents the annuity factors using United Nations model life table and various assumed interest rates.

Rough estimates of Pillar II pensions by different interest rates

Interest rate	0%	1%	2%	3%	4%	5%
Annuity factor at 62	18.8	16.8	15.2	13.8	12.6	11.5
Reciprocal value of the annuity factor at 62	5.3%	5.9%	6.6%	7.3%	8.0%	8.7%
Monthly pension with SKK 1 million balance	SKK 4,430	SKK 4,950	SKK 5,490	SKK 6,050	SKK 6,630	SKK 7,220

Assumption: Life expectancy at birth 75 years (United Nations model life tables)

The following observations are made:

- The annuity factors are sensitive to the actuarial assumptions. If the assumed interest rate is higher by 1%-point, then the resulting pension amount would increase by about 10%.
- The above pensions are non-indexed therefore their purchasing power will decline over time due to inflation.
- The above pensions are for single retiree. If a pensioner dies immediately after the retirement, no payment will be made. If survivors' pensions need to be paid, then the level of pension will decrease accordingly.

It is reported that the Pillar II should provide at least 60% of the subsistence minimum level (currently at about SKK 5,000 per month) as pensions from Pillar II and any excess amount in the balance can be paid in the form of programmed withdrawal for the duration specified by the account holder.

In addition to uncertainty of the benefit level, the Pillar II benefits are constrained by the following potential drawbacks:

- The Act does not specify who will be the providers of life annuities. In view of the adverse selection and longevity risk, market provision of life annuities will face difficulties.
- The use of unisex life table will put private pension funds to cope with a longevity risk due to sex difference in life expectancies. (On average, provision of life annuity for females is more costly than for males. Therefore under the unisex table, private pension funds are given an incentive to get male customers and a disincentive to accept female customers).
- In the framework of the private provision of life annuity, indexation of benefits is difficult even if it is limited to price indexation. This will make the pensioners vulnerable to poverty in the later stage of the retirement life.
- Privatisation implies the limitation of income redistribution through public pension system. Therefore, it results in a greater income inequality in old-age. Workers with low income, shorter working period or more family members will be adversely affected by this system. Unless pension system guarantees a certain minimum level of protection, this would result in the increase in old-age poverty, which would in turn cause increased demand of social assistance.

Some Central European countries, such as Poland and Hungary, have implemented similar reform earlier. The first generation of workers under Pillar II are going to retire in 2009 in Poland, and in 2012 in Hungary. The experiences of these countries could give reference information for Slovak Republic.

9. Workers' (mis-)conception on private pension savings

It appears that workers have a strong preference to private pension savings, as evidenced by the small number of workers who left Pillar II during the open period. As noted earlier, this may partly be a consequence of the aggressive promotion of private pension fund companies. In addition, many people have a general propensity for the private ownership of financial assets including the possibility to inherit the balance to their families in case of death. Dissatisfaction with public services in general and distrust to the government scheme with uncertainty of future pensions intensify such tendencies.

However, the general public did not seem to be fully informed of the provision of the benefits from pension savings. As analysed above, although the Act on pension savings provides the general rules of annuitisation, the key mortality and interest assumptions are not specified. Moreover, as the private provision of annuity works quite differently from public pensions, it requires fair amount of knowledge of financial markets to fully appreciate the advantages and disadvantages of Pillar II benefits. This means that most workers had to make decision on the entry or non-entry in Pillar II in the absence of key information on the impact on the individual pension benefits.

The introduction of the privately managed pension can be regarded as a *de facto* partial opting-out from the public pension system. It is this aspect that has attracted a large number of workers including those who are close to retirement age.

10. Political aspects and consistency of pension policy

Pension is a long-term system, and pension reform is a long-term process. Thus consistency in the policy and the government's continuous commitment are critical for the successful implementation of the pension system.

However, since the enactment in 2003 and 2004, the Pension Act has so far been amended for 20 times and the Pension Savings Act has been amended for 8 times. Frequent changes due to political intervention undermine the long-term consistency of the pension policy and may risk confidence in the pension system of the contributors and pensioners. Interferences to promise generous provisions, motivated by short-term political objectives, will not be supported by the future generations who will have to pay their costs.

Such frequent policy changes reflect the fact that the pension policy has become a political issue between liberal parties and social democratic parties. Many people interviewed admitted that the political process of 2003 pension reform was not transparent and lacked sufficient consultation with key stakeholders and that the decision was made hastily. Many also confirmed that the decision in 2003 on the rate of contribution to Pillar II was politically motivated without due consideration of the magnitude of transition costs based on quantitative forecast.

A comprehensive review of the current pension system needs to be conducted instead of implementing a series of *ad hoc* amendments. Such a review should include an examination of:

- (a) The impact of benefit structure of Pillar II on different individuals (by age, by income) under different financial and economic assumptions (e.g. interest rate, mortality rates);
- (b) The short- to medium-term forecast of financial operations of the Social Insurance Agency fund, including the plan to finance the transition costs;
- (c) The long-term projection of the Social Insurance Agency fund and the effects of different measures explained in Section 5.

11. Towards a rational decision based on a broad consensus of all stakeholders

The Slovak pension system is facing an imminent challenge of transition costs and a long-term concern with sustainability in the rapidly ageing population. Therefore, any measures to restore the stability of the system would likely to ask all the relevant stakeholders to share such burdens either by paying more contributions or receiving less benefits. At the same time, the pension system should meet basic minimum standards to ensure adequate level of income to the protected workers and their families.

In order to reach an agreed policy to stabilize the pension system in the long run, a wide range of policy options should be presented together with the assessment of their financial impacts. The government's role is crucial in developing and analysing various policy options and explaining them to the key stakeholders. Based on the thorough assessment of the policy options, efforts should be made to build a consensus by a broad range of relevant stakeholders.

For this purpose, a Pension Reform Working Group can be created. The Working Group will consist of key stakeholders and offer a public forum for examining various policy alternatives. The relevant departments in the government should serve as Secretariat which provides technical support to the Working Group. The ILO can assist the Working group and the Secretariat.

A well-informed and participatory policy dialogue lays the foundations for democratic process in the policy making, and assists in finding solutions based on a broad consensus, thereby improving the effectiveness of the pension system. From this point of view, the capacity of workers' and employers' organisations should be strengthened, so that the voices of these stakeholders are properly heard in the discussion of the future pension policy.

12. The way forward: Further ILO technical co-operations

The Slovak pension system is facing complex constraints. However, it is hoped that through an informed policy making process and consensus building effort, one can achieve an agreement on the policies to stabilize the pension system in the long run.

To contribute to the discussion of the pension reform, the ILO stands ready to provide further technical assistance as a follow up to this report. In particular, the ILO is willing to assist the Pension Reform Working Group and its Secretariat once they are established. The following areas have been identified as possible ILO involvement:

- Participation as resource person in policy dialogue at national and individual tripartite levels.
- Analytical work on the design of benefits from the Pillar II, including the sharing good practices of the countries in the region.
- Policy oriented research to encourage longer employment for elderly workers with a view to sustain growth in the declining working age population.
- Technical cooperation to improve the financial projection model (ESTEEM) to forecast the multi-pillar system.
- Design and conduct a training course for contribution collection for the implementers in the Social Insurance Agency.