PENSION REFORM

PART 3

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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. Confidence 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.

Pension systems in selected countries

Chile

Pension reform in Chile is often a subject of discussions on alternative ways of pension system reform financed on the pay-as-you-go basis. Its essence lies in the introduction of individual capitalisation to the pension system, carried out by private institutions on the basis of competition. Through its emphasis on the ownership rights principle and its forecast considerable impact on the economic growth, the creation of national savings and the development of financial markets, Chile inspired other Latin American countries (Peru in 1992, Columbia and Argentina in 1993, Uruguay in 1995, Mexico, Bolivia and El Salvador in 1996, and Nicaragua in 2000) to fully or partially replace the pay-as-you-go pension system by the capitalisation system of individual accounts administered by private institutions. The launching of the Chile's pension reform dates from 1 May 1981.

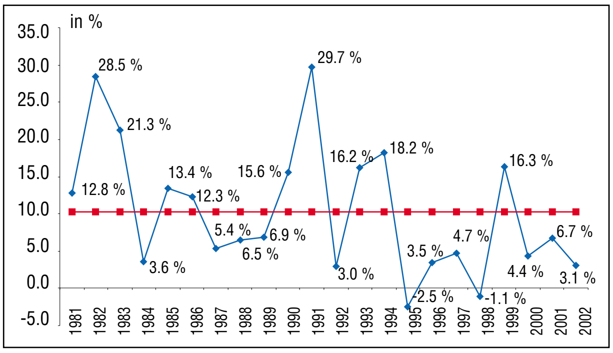
The new pension system was based on the following principles:

- payment of contributions to the personal pension accounts and their appreciation,
- provision of old-age, invalidity and survivor pensions,
- free choice of the institutions to administer pension funds,
- private, mutually competing institutions – AFP (Administradoras de Fondos de Pensiones),
- choice of three different methods of old-age pension provision,
- guarantee of a minimum pension from the side of the state.

Participation in the new system was compulsory for all working people who began to work for the first time after 1 January 1983. This means that the changeover from the old system was voluntary for all citizens already paying their contributions to the pay-as-you-go system. By the end of 1983 77% of people had moved over to the new system. Employees who decided to change from the old to the new system, but had already had been paying contributions, received as a compensation for these contributions paid "recognition bonds". The value of these bonds was calculated on a case-by-case basis according to a model taking account of the contribution period and previous wages. These bonds bear interest on the basis of inflation and their real annual yield is at the level of 4%. They form assets on the individual's personal account and are payable upon retirement. The key role played in the new systems is that of private companies – AFPs, with the delimited line of business. AFPs are joint-stock companies whose shareholders are large multinational financial groups. Their share capital is in the case of 5,000 clients USD 250,000, and when exceeding 10,000 clients it is USD 500,000. Currently 7 AFPs operate in Chile, where the three largest ones hold approximately 80% of the market. Throughout the whole period since pension system reform yields have been reaching the unbelievable level of 10.3% p.a. The total real value of assets in the administration of AFPs grew in the period of 1981 to 2000 at an average annual rate of 29%, from the amount of USD 300 million (0.9% of GDP) in December 1981 to the value of USD 42.27 billion (58.2% of GDP) in December 2000. This strong growth is caused on the one hand by the mass shift of the working persons into the new system and by a high average annual yield together with a high proportion of contributors into the system over beneficiaries drawing a pension. The average annual rate of growth of assets in pension funds in 2002 to 2030 is expected to be at the level of 7.1%, which would mean an increase in the value to USD 177.6 billion (87.8% of GDP).

Life insurance companies play two roles in this new system. On the basis of a contract with an AFP on disability and survivor insurance they pay additionally into the client's pension account in the case of his/her disability or death the sum necessary for purchasing the annuity. At the same time they provide annuities in the capitalisation system. Collection of contributions is realised on a decentralised basis. Contributions are collected by banks, AFPs and special institution (PREVIRED), serving as a clearing centre, which AFPs have created for this purpose. An interesting feature is the fact that in the following 20 years since the pension system reform in Chile the share of the debt in GDP increased only slightly (from 48% in 1981 to 49% in 2001), meaning that the prevailing part of the transformation costs of the reform was financed by savings in the state budget and not by increasing government debt.

Rate of real annual yield of the AFP system in Chile (1981 – 2002)



Croatia

Pension system reform in Croatia was launched in 2000. Similarly as in Slovakia, it was a reaction to the worsening demographic development and the possible catastrophe in the form of an unsustainable pay-as-you-go system in the future.

The second, capitalisation pillar was compulsory in Croatia for all employees younger than 40, those in the age range of 40 to 50 years were able to choose. The result was a seemingly successful reform where of the potential 1.2 million participants, more than 1 million joined the reform. However, in Croatia only a quarter of contributions (5% of an employee's income) flows into the capitalisation pillar. At present pension funds thus administer approximately EUR 990 million (approx. SKK 36 billion). One of the specific features of the Croatian reform was the limitation of the activity of brokers in the whole process. In fact, sales agents do not have the possibility to sign contracts, each client must sign the contract personally at the central state register (REGOS). Financial brokers thus merely had the task of persuading a potential client of the justification for the second pillar and to convince him/her to visit REGOS and sign a contract.

Seven fund management companies entered the market in Croatia, where the largest share of which was taken by those who were backed by the best brand and densest network of active advisors. Following the initial, important period the market became consolidated, the reason being the rule that an asset management company must have at least 50,000 clients. Out of the total number of seven companies at the start of the system, today only four operate in this market.

Consolidation in the Croatian pension market

Pension fund	Initial market share	Current market share
AZ	39.6 %	39.8 %
RBA	32.3 %	32.7 %
PBZ-CO	16.6 %	16.7 %
Plavi	6.1 %	10.8 %
Erste	2.5 %	
Helios	2.5 %	
HA 1	0.4 %	

Strict rules and restrictions apply in asset administration in Croatia. At minimum 50% of assets must be invested in Croatian government bonds and at maximum 15% of assets may be in short-term financial investments and only 15% of assets may be invested abroad. The share of domestic equities may reach 30% of the value of assets administered, however, these values cannot in practice be fulfilled, since, as is the case in Slovakia, the Croatian capital market is very weakly developed.

Total distribution of investments of pension funds in Croatia (August 2004)

Croatian equities	3.98 %
Croatian government bonds	67.99 %
Croatian non-government bonds	7.11 %
Cash	9.12 %
International equities	7.61 %
International bonds	4.17 %

Legislation contains also compensations in the case of a fund's poor performance. These have caused a coordination in the purchasing of securities into funds' portfolios. While this coordination does not officially occur, it is nonetheless a public secret and is apparent from the composition of individual funds' portfolios. The risks of losses and subsequent compensations are sufficiently high for funds to ignore competitive rivalry.

Performance of individual pension funds in Croatia p.a. (as at 30. 6. 2004)

Pension fund	1st Q 2004	2nd Q 2004	from 04.2002 to 07. 2004
AZ	-1.63 %	0.68 %	9.94 %
Plavi	-1.51 %	1.07 %	6.90 %
PBZ-CO	-1.60 %	0.70 %	7.44 %
RBA	-1.63 %	0.49 %	6.58 %

Pension system reforms in the V4 countries

The first time the V4 countries realised the need for reform was at the beginning of the 1990's. Poland and the SR came around to taking any steps only after the overall tightening of the macroeconomic situation – in 1997 and 1999 respectively. These two countries made their reforms in two stages – in the first they made changes in the existing system and in the second they introduced a new fund – a privately managed – pillar. From among the transitional economies Hungary was first to make any changes in this field. As early as 1992 – 1993 it undertook to create and launch a voluntary pillar. Voluntary private pension funds began to operate here in 1994. In 1997 Hungary then, similarly as the other mentioned countries, undertook changes to the existing pension system. In the case of the Czech Republic there is little to say on the reform. This country as the only one of the original V4 has not implemented a multipillar pension system. It has simply retained its existing statutory pillar which it supplemented by funds operating on a voluntary basis.

The new system was launched in the individual states in the following years – Hungary 1998, Poland 1999, and Slovakia 2005. A substantial change was the introduction of the multipillar structure of the pension system. As a rule this means the existence of three pillars with the following characteristics:

The 1st pillar is the basic statutory compulsory pillar. It is financed via insurance premiums paid by the persons insured. The resources are used for paying out current liabilities towards pensioners.

The 2nd pillar is basic compulsory capitalisation. Contributions are deposited to specific accounts of participants (savers), where they are invested and appreciated. This brings actual saving for one's own pension.

The 3rd pillar is supplementary, voluntary. It is additional pension insurance financed from collected contributions. Most frequently it is based on the savings of individuals or on programmes supported by employers.

Efficiency of a pension system

The efficiency of pension systems following reforms can be assessed partially on the basis of the following criteria

1. Costs for the provision of institutional functioning of the pension system.

The aim of the reform was to reduce administrative costs, and this by means of introducing the capitalisation pillar, centralisation of the contribution collection and decentralisation of pension payment. The operation of pension funds (PFs) is to unburden 1st pillar institutions, which have a high share of administrative costs. PFs are profit-making organisations and though at the start of their operation they have significantly higher costs connected with marketing and investment activities, room is created for covering their costs from revenues. At the same time, once their positions have stabilised, competition itself should work to cut costs. Operating costs of PFs in Hungary and Poland move within the range of 5 – 10% of the contribution's value.

In the SR the law governing the activity of the 2nd pillar defines in detail what fees a pension fund management company can request from its clients and sets in two cases (remuneration for administration of a pension fund, remuneration for administration of a personal pension account) the maximum level of the fee (remuneration). In the case of the choice of contribution collection it was the centralisation via the 1st pillar institutions received the most support. The basis for this decision was the comparison of costs for centralised collection (transfers of contributions into the 2nd pillar institutions, costs for the information system working in the 1st pillar) and costs for decentralised collection (additional costs on employers, making contribution collection less transparent, possible reduction in the contribution collection in consequence of non-transparency, costs for registration system of each PF). Many analyses prove that the latter costs are higher than those related to the transfer of centrally-collected contributions.

2. Share of expenditure on pensions in GDP

Via reform the V4 countries have successfully prevented the excessive forecast growth in expenditure on pensions. The SR and Hungary have in this way held their position over the past three years at around the limit of 10% of GDP. The conditions for this situation were created by the lower indexation of benefits, by increasing the retirement age, by making the pension provision rules tighter, by adjusting the pension model and by removing the advantages of early retirement.

3. Development of pension system financing deficits (surpluses).

The efforts of the candidate countries to entry the EMU by fulfilling the strict Maastricht Criteria puts pressure on them to reduce their public finance deficits, in particular by cutting public expenditure. The pension system reform underway also contributes to this reduction.

In fact, a great part of public expenditure goes on pension benefits. In Poland, for instance, it is up to 50% of expenditure, in the Czech Republic one third.

4. Level of pension insurance premiums.

Pension reform creates room for reducing the level of contributions. An important determinant for this step is mainly the development of deficit financing of the pension system in previous years. In Poland and the Czech Republic the rate has not been changed by the reforms. In Poland the old-age pension insurance premium, at the level of 19.52%, was merely divided between the two pillars and the demographic reserve fund. In the Czech Republic the rate of 26% represents income to the pay-as-you-go system. Although the reform made in the Czech Republic was insufficient, it has ensured the sustainability of the mentioned rate (otherwise it would have had to have been increased back in 2000 to 28% and by 2030 progressively to 45% in order to maintain the present level of pensions). The SR and Hungary recorded an increase to 28.75% and 31% respectively. The reason for this growth in the SR was the delay in launching the reform. Following the launch of the 2nd pillar a reduction in the contribution burden is being considered, which however will not be of any radical nature due to the mentioned poor state of the Social Insurance Company. Compared to the system in Chile, where only the capitalisation pillar is in operation, the rates of contributions in all the three countries discussed above are high. In Chile the contribution represents only 10% of the gross wage and a further 2.31% is contributed for the remuneration of administration costs.

5. The role of the state.

In ensuring the efficient activity of the 2nd pillar, as well as the cooperation of both pillars a key role is played by government. In all four countries the state operates in particular as the creator of legislation and supervisory body. Special institutions of public-legal nature are as a rule created for the administration of the 1st basic compulsory pillar..

6. Setting the pension valorisation and the manner of coverage.

The benefit valorisation system has also seen change in the individual countries. By way of the new valorisation the countries are endeavouring to reduce unexpected expenditure on pensions as well as to prevent their excessive growth, for the coverage of which no funds are available. Both the Czech Republic and Slovakia set a precise date for increasing pensions. The Czech Republic takes into consideration the growth in prices and the growth in wages will be taken into account only once every two years. Slovakia and Hungary, where there was no valorisation mechanism in the previous period, adoption indexation based on the Swiss formula (a wages : prices weighting of 50:50).

Advantages and disadvantages of the reformed pension systems

The first positive feature that can be included straightaway is the introduction of the multipillar structure of a system with the option of appreciating resources deposited, though a dominant position is still taken by the pay-as-you-go pillar. An exception in this structure is only the Czech Republic, which is to face further important changes in the coming period.

A positive evaluation may also be attributed to countries' battles against the privileged position of certain groups of citizens, or working classes. In Poland farmers remained excluded from the system. In the SR the same applies to the employees of the forces. The new system also cancelled the advantages of early retirement.

The reform required an increase in the retirement age (only Poland is an exception, since its limit for retirement age was higher than in the other three countries already prior to the reform's onset). On the other hand, only Hungary and Slovakia succeeded in equalising the retirement age for both sexes (the age retirement limit is the same for both men and women). The Czech Republic even kept the differentiation in the case of women, according to the number of children brought up.

Poland and Hungary desisted from a strictly set contribution period. The motivation to work longer lies in the dependence of the pension received on the length of the contribution period. Polish law sets only a minimum retirement age, this nevertheless need not to mean any obligation to finish work at this age. Slovakia also sets a minimum retirement age, though retains the institute of a minimum period for contributing premiums.

Only Hungary and Slovakia have undertaken a change to the rate of the insurance premiums. The introduction of a multipillar structure however creates a basis for its future reduction. Nevertheless, much depends on the development of the pay-as-you-go system's deficit. Poland and the Czech Republic have avoided taking this step.

In all these countries the ties between benefits and contributions have increased – excessive redistribution in favour of low income groups has been removed, for which it is primarily the adjustment to the pension model that deserves credit.

The pension indexation system has also undergone adjustments. Following reform Poland and Hungary also adopted the valorisation mechanism, where this had been absent in the universal pay-as-you-go system. By means of setting the procedure for increasing pensions the countries are trying to reduce the costs relating to this situation. Likewise, they will avoid situations where the budget does not take into account valorisation and does not have sufficient funds to cover it.