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Current pension system in the Slovak Republic

The current pension system in the Slovak Republic is mainly characterised by a solidarity principle, the pay-as-you-go (PAYG) financing (supplemented by state budget financing) and strong public component, administered by the Social Insurance Agency (SIA)[1]. The private pension schemes have not been well developed for the time being, however some conditions have been already created for operation of private supplementary schemes (part 2).

1. Public PAYG pension system in the Slovak Republic

1.1 Main characteristics

Public pension system fully or in part covers functions of pension security and support of income in old age, in physical and mental disability, and in the event of death of a member of the family. Main resources financing these systemic public pension benefits in Slovakia consist of compulsory pension insurance contributions. Employers must pay 21,6% and employees 6,4% of gross nominal wages to the SIA. In respect of secondary school and university students, persons caring for a child or a close person, persons drawing disability pension, persons doing their basic military service, where the incomes of these do not exceed the amount of the minimum assessment base, contributions are paid from the state budget, and the National Labour Office pays contributions to the SIA in respect of persons receiving unemployment benefits.

The Social Insurance Agency, in addition to systemic benefits, also provides paying out non-systemic benefits (such as the social pension, wife's pension, pension on the grounds of participation in resistance movement, etc.). Resources of financing these non-systemic benefits are transferred from the state budget.

1.2 Main problems

Revenue side

The collection of contributions for public pension security (in 2000 comprising 7,5% of the GDP) is insufficient to funding public pension expenditure, even more than the year-on-year increase in these collected pension insurance contributions was gradually falling, namely from 24.5% year-on-year increase in 1995, to only 0.4% in 1999. Higher year-on-year increase was 17.8%, respectively 7.1% (adjusted) in 2000.[2]
The inadequate collection of public pension insurance contributions in the SR is influenced mainly by following interrelating factors:

- low social contribution (and tax) base, accompanied with general financial problems of economic subjects, insufficient economic performance of enterprises (except the year 2000 when certain improvement was achieved) and (labour) productivity, with a subsequent impact on decreasing year-on-year increase in gross nominal wages (from 14.3% in 1995 to 6.5%)
- excessive total social contribution (and tax) burden of economic subjects, caused also by high social contribution rate (50.8% of gross nominal wages)[3], what has in turn negative influence on social contribution base
- growing rate of unemployment (from 13.1% in 1995 to 18.6% in 2000)[4] and

[1] Social Insurance Agency was established by special law at 1 January 1995. It is public institution, including in general government
[2] In 2000, adjustment of collection of pension insurance contributions corresponds with government transfers to the SIA in amount 6.05 billion SKK. These payments followed from sales of shares of Czechoslovak Trade Bank (CSOB) and Slovak Telecom (ST) and they was intended to pay off SIA ´s claims visa-a-visa Slovak Railways (ZSR) and state health institutions.
[3] The contribution rates for pension, sickness, unemployment and health security payable by employers and employees on gross nominal wages, exceed the rates in the neighbouring transforming countries – for example in the Czech Republic by 3.3% and in Hungary by 9.8%. Moreover, the burden of employers and employees by social contribution liability in Slovakia is 26.0% higher than the average rate in OECD countries.
[4] According to statistical select survey of the Statistical Office of the Slovak Republic (SO SR)

- others (for example reduced payments from the state budget in respect of economically non-active population (as the result of changes in the percentage of the assessment base for insurance payments payable by the state).[5]

Expenditure side

Expenditure for public pension benefits had been significantly increasing between 1995 and 2000 (usually more than public pension revenue). Increased expenditure on pension security and requirements for pension benefits are determined mainly by:

- unfavourable demographic development, particularly increase of people of post-productive age (and the rise of their share in the total population, from 17.5% ratio of post-productive population to total population in 1995 to 18.0% in 1999, respectively according to projections of MLSAF SR to 26.4% in 2025), coupled with the increasing life expectancy in general and (projected) expectation of life rising for citizens of retirement age[6]
- legally binding increases of pensions (in case of growing the average nominal wages in economy by 5%, and/or the increased living costs, measured by CPI, by 10%)
- worsening development in relevant socio-economic factors, mainly rate of unemployment and net income of households, low savings of pensioners, and political agreement in the Parliament on rate of indexation of pension benefits.

Projected demographic development in general, low retirement age and anticipated increase of currently low average old-age pensions are significant risks for public pension expenditure in the future.

Financial imbalance of public pension system – need of a change

Consequence of strain between insufficient collection of public pension revenue from contributions and growing requirements for public expenditure for pension benefits is:

- deteriorating of results of economic performance of the pension system in the present (until 1997 steadily worsening to the deficit of SKK 5.9 billion in 1999, respectively to 3.3 billion SKK in 2000 (even more 9.4 billion SKK without "special government transfers" – see footnote 2)[7]
- further deteriorating of economic performance of the pension system, with the situation unchanged, in future (annual increases of deficit in pension security are expected to continue, reaching, for example, SKK 44.5 billion in 2030)[8], with potential impact on accumulation excessive "implicit debt" of the system. MLSAF SR calculated the current amount of this debt (with a horizon of 60 years), putting its figure at SKK 1,270 billion in constant prices (194.4% of the GDP in 1999)[9].

Main problems (and potential risks) of current public pension system in Slovakia followed mainly from:

- mentioned factors affecting on insufficient collection of insurance contributions and factors affecting on increasing requirements for pension expenditure, with impact on rising financial imbalance
- falling pension contributors to pension beneficiaries ratio, respectively increasing dependency ratio of pensioners upon pension contributors. The dependency ratio has gone up in Slovakia from 57.2% of all pension beneficiaries (or 37% old-age pensioners) in 1997 to 63.6 % dependency ratio of all pensioners (and 41.8% old-age pensioners) in 1999.[10]

[5] For 1994, National Council SR (NC SR) approved payments from the state budget at 26.5% of 90 % of the assessment base of the minimum wage (SKK 2,450) to the SIA in respect of economically non-active population, but in 1999 the NC SR approved payment of only 27.5% of 15% of the assessment base of SKK 2,700. However, for 2001, NC SR approved payments from the state budget at 28,0% of 100% of SKK 2,400.

[6] There is statistical evidence (on the basis of tables of deaths for 1998, SO SR) that in Slovakia, the expectation of life for males of retirement age (60, by law) is, on average, 15.7 years, and for females, (57, by law), 22.8 years.

[7] On the other side, only systemic benefits are financed from pension insurance contributions, while non-systemic benefits (1.6 bill. SKK in 2000) are financed from the state budget (mainly from taxes). Therefore, the official balance of public pension insurance fund corresponds deficit in amount 1.7 bill. SKK in 2000 (without any adjustments)

[8] According to the calculations of the MLSAF SR (using the model approach) The concept of social insurance reform in the Slovak Republic, MLSAF SR, 2000

[9] Concept of social insurance reform, MLSAF SR, 2000

[10] According to projections of MLSAR SR, the dependency ratio of pensions to contributors could deteriorate from

- basic systemic distortions, mainly predominated public and compulsory component of the system and non-stimulating PAYG financing (with weak link between contributions and pension benefits, and etc.) and
- other distortions in the system (short period of insurance resulting from low pension age, different pension age for men and for women, existence of non-systemic benefits, and etc.).

Current pension system in Slovakia therefore requires a systemic change – mainly through shifting the weight on capitalisation financing, with an emphasis on creating conditions conducive to more marked use of voluntary complementary and individual private pension insurance schemes. Several conditions have been already established for operation of private pension funds in Slovakia and several conditions are included in government concept of social insurance reform

The concept of the social insurance reform (approved by Government of the Slovak Republic in 2000) have also proposed the transition to a multi-pillar, diversified system of a financing mix, the introduction of a new system relying on capitalisation of the resources raised and other systemic change (derivation requirements from the amount and period of contribution paid, gradually unification pension age for males and, introduction the institute of early retirement with the amount of pension which will take account of its early drawing and abolition all cases of preferential treatment from the system and abolition all non-systemic benefits in the system).

75.1% in 1999 to 127.4% in 2025, The concept of social insurance reform, MLSAF SR, 2000

According to the government concept of social insurance reform, the future pension system could be based on three pillars:

I. Mandatory pillar based on pay-as-you-go funding. The idea is to progressively reduce current basic pension security from the current level to the inescapable measure of social solidarity. The pillar will be further administered by the Social Insurance Agency, and it should be guaranteed by the Government of the SR.
II. Mandatory pillar base on individual capital accounts (currently non-existent). According to the concept, the pillar should be administered by the SIA and coordinated and financially guaranteed (up to the level of the principal and inflation) by the Government.
III. Complementary (voluntary) pillar based on privately-managed pension funds (the system is currently represented by the so called supplementary pension schemes (see below). However, commercial insurance companies are interested as well.

It is anticipated that in the target state the contributions to the pillar I. will account for 2/3 and contributions to pillar II for 1/3 of total burden. Combined resources in pillars 1 and 2 should in the target situation cover around 50 to 60% of life-long average monthly earnings from which insurance contributions were paid – up to a maximum of the amount equal to three times the average monthly wages in the economy of the SR.

The third pillar should in the final stage guarantee pension benefits corresponding to 20-25% of life-long average monthly income

However, before adoption of relevant legislation, measures should be adopted to prevent the financial collapse of the pension security, e.g. to eradicate differences with declared universality and equity of the future system, to solve in a systemic way the age limit for retirement, to restrict or at least minimise concurrence of pensions, to introduce a claim to benefit link in insurance contribution paid, and to period of contribution and make the entitlement conditions to pension security benefits stricter.

2. Private pension funds in the Slovak Republic

The system of supplementary pension schemes (SPS) was introduced in Slovakia in 1996. According to the legislation valid since 1996 the system was open only for employees of those enterprises, which concluded agreements with the Supplementary pension insurance company (SPIC). However, the system was not available for employees of budgetary organizations (organizations funded by the state budget) as well as self-employed individuals.

Under such agreements insurance premiums for employees were paid by both, the employee and the employer. According to the system, contribution of employee was tax-deductible in full amount, contributions of the employers have been tax-deductible up to 3% of nominal value of wages of insured persons.

At the beginning of 2001 the amendment to relevant legislation became valid that removes some discriminations within the SPIC system and makes it available to much wider spectrum o clients. The system is now open to all employees including employees of budgetary organizations regardless of the agreement between employer and an SPIC as well as to self-employed. However, the system is still not available for security forces (military and police). Simultaneously, motivation for participation in the system was enhanced through reduction of income tax on SPS benefits from 15 to 10%. On the other hand, limit was introduced for income tax-deductible insurance premiums for employees and self-employed individuals (up to SKK 24,000/year or 10% of gross income)

Contributions and benefits are based on Defined Contribution Plans. Level of benefits depends on contributions and share of individual beneficiary in income generated by the SPIC.

According to the Slovak legislation Supplementary pension insurance company is a legal person established by employer, association of employers, trade unions or combination of these subjects solely in order to provide supplementary pension insurance. Establishment of SPIC is subject to license granted by government. Such license is based on recommendation of the Ministry of Labor and Ministry of Finance. If the license is granted the SPIC is registered in the special registry of the Ministry of Labor. An important part of request for a license as well as the entry into the registry is, among other requirements, also identification of depository bank. Such bank must have headquarters in the Slovak Republic and has to hold a license of the Ministry of Finance.

The highest body of SPIC is board of directors. The board consists of representatives of employers, insured employees/self-employed individuals and eventually also pension beneficiaries. The same principle is used for creation of supervisory board.

The materials necessary to obtain the permission for the operation of an SPIC include also financial plan (for 1 year) and long-term financial plan (5 years). The plans including any adjustments are to be submitted to the ministries, which act as supervisory bodies of SPIC. The plan must include, beside other items, also kinds of investments that the SPIC will used to raise the value of funds as well as projection of costs including operation costs. Operation costs cannot exceed 6% of revenues within the first five years of operation of the SPIC and 3% after period. Profit of SPIC is to be divided to the reserve fund (2.5%) or to the benefit of insured persons.

The supervision over SPIC is a matter of criticism since the SPIC do not come under supervision of the Bureau for Financial Market that has capacities to control investment activities of SPIC. On the other hand, the division of supervision authority between ministry of labor (responsible for supervision in the areas related to fulfillment of defined contribution plans, protection of interests of insured person and pension beneficiaries) and the ministry of finance (that controls fulfillment of financial plans, observance of investment conditions and operation of depository bank) can result in confusions and lack of coordination.

Currently (April 2001) there are four SPIC operating in Slovakia. By the end of 2000 they had 180,000 clients and managed funds accounting for SKK 3 billion (USD 65 million). Average gross appreciation rate according to the Association of supplementary pension companies reached 13%.

Table 1 Supplementary pension insurance companies in Slovakia (as by the end of 2000)

	Tatry-Sympatia	Pokoj*	Lipa	Stabilita
Number of clients	105,030	10,500	13,644	53,430
Assets (SKK million)	1,900***	174	200**	730
Appreciation of assets	13.8%	11.1%	9%	14.2

*until the end of 2000 known as Horizont
**as by the end of March 2001
***estimate MESA 10

Source: SPIC Tatry-Sympatia, Pokoj, Lipa, Stabilita

The spectrum of assets that the SPIC can invest in is quite broad:

- bank deposits
- government bonds and treasury bills, bonds of the National Property Fund
- bonds traded at the stock exchange (up to 20% of funds)
- shares of mutual funds (up to 20% of funds)
- foreign securities traded either on domestic or foreign stock exchange (up to 15% of funds)
- real estate (up to 10% of funds)

However, current portfolio of existing SPIC is rather limited. We can illustrate it on the example of SPIC Pokoj.

Table 2 Portfolio of SPIC Pokoj (as by March 2001)

Short-term deposits	23%
Medium-term deposits	56%
Government bonds in SKK	21%

Source: SPIC Pokoj

In the future, portfolio of assets should mainly consist of:

- SKK Eurobonds and other securities of subjects with rating A and higher
- Eurobonds, T-Bonds, corporate bonds and securities in foreign currency with rating corresponding to sovereign rating of Slovak Republic and higher
- Mortgage bonds (currently not allowed by law)
- short-term bank deposits

When investing in a bank products, the SPIC, volume of investment in products of any bank cannot exceed 40% of its equity capital or 25% of value of SPIC funds.

Simultaneously with development of SPS the system of commercial investment life insurance and pension insurance have been developing in Slovakia. In 1999 prescribed premium in life insurance increased by 26% reaching SKK 8.3 billion. Such development was recorded in spite of the fact that insurance premiums under commercial life or pension insurance are not tax-deductible and benefits from this kind of product is taxed with higher rate (15%)

It is no surprise that commercial insurance companies are interested to participate in the projected third pillar of the pension reform and want to balance the conditions for their operation with those for supplementary pension insurance companies.

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