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PART IV

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Chapter 15

PENSION REFORM IN POLAND[1]

by
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Origins of reform

Poland introduced a new pension system in 1999. The need for pension reform resulted from high pension expenditures in Poland that peaked in 1995, exceeding 15% of GDP, combined with projected ageing of the Polish population.

The pension system offered relatively high old-age pensions, with the average replacement rate at around 70%. Additionally, the average retirement age was lower than that specified in the legislation, as there were many early retirement privileges offered to some groups of the population. As a result the average male retirement age in Poland was 59 and the average female retirement age was 55.

Demographic projections show that the share of the female and male population aged over 60 and 65, respectively, in the total population would rise from the current 15% to almost 24% by 2030. This is due to the fact that the baby-boom generation is going to reach retirement age during the period 2010-2020. Additionally, Poles are living longer and birth rates are at an historical low.

The combination of demography and of the structure of the old system would have made the Polish pension system unsustainable in the long run. In order to accommodate rising expenditure, social security contributions had been set at a very high level, 45% of earnings, and could not be increased further. The shape of the reformed system was designed to meet the challenges of the demographic situation and make it less vulnerable to changes in the labour market.

In the second half of 1990s, pension reform in Poland was the subject of intense debate among the various actors. The government was not only an actor in this process but also participated as a moderator in the discussions between other institutions and organisations. The debate on the reform ended with the establishment of a special body entrusted with a mandate to prepare the reform programme. In 1997, the reform programme – *Security through Diversity* – was submitted to the government.

1. This is an extended and revised version of a paper published in *Emergo Journal of Transforming Economies and Societies*, Vol. 9, No. 1, Winter (2002).

Following the presentation of the reform programme the government started to garner support from social partners and the public. The most important *fora* for discussion with the social partners were meetings of the Tripartite Committee. The social partners were given a role in the supervision of the institutions administering the social security system – the Social Security Institute (ZUS), and the Superintendency of Pension Funds. The government also co-operated with unions on the dissemination of the reform concept, training and informing union representatives about the reasons for and the expected outcomes of the proposed new system.

Public relations were an important element in building consensus around the reform. From the beginning of the reform activities, public relations were one of the tools extensively used by reformers. Public opinion polls and focus group interviews helped to test the proposals, and meetings with journalists enhanced the dissemination of information. The press was a forum of discussion between various actors, most importantly between the younger and older generations. The most important goal was to build a large consensus on the reform across various political parties, social partners and generations. It was only in this way that enough support for the reform was generated so as to complete the preparations for and launch the changes in 1999.

The path chosen by Poland was to replace the pay-as-you-go (PAYG) system with a multi-pillar system, with each pillar exposed to the different types of risks affecting the labour and financial markets. Both the first and second pillars are mandatory and operate on a defined contribution (DC) principle. These two obligatory pillars will provide a lifetime pension for all participants. The first pillar is a defined contribution PAYG system with notional accounts (PAYG NDC), whereas the second pillar is fully funded with individual privately managed accounts. The voluntary third pillar will provide an opportunity for higher pensions for those who decide to save more.

The retirement age has been set at the same level as in the old system (*i.e.* 60/65 years). The system offers also a minimum benefit guarantee that would top-up pensions of people with lower earnings and/or shorter working careers. Currently, the minimum pension level is equal to approximately 25% of the average wage. The minimum pension is indexed at the same rate as all pensions, *i.e.* not lower than inflation plus 20% of real wage growth annually.

Social security contributions (including the funded pillar share) are collected by ZUS, which then transfers a part of the contributions to private pension funds. The total contribution rate reaches almost 37% of gross salary (that covers taxes and approximately a half of social security contributions), of which 19.52% serves to finance old-age pensions. The rest covers the risks of disability and survival (13%), work injury (1.62%) and sickness (2.45%).

All insured people born after 1948 are covered by the new system.[2] Those born between 1949 and 1968 could opt for the new two pillar system or for the PAYG alone. Out of this group, approximately 55% decided to join the funded pillar (younger people more frequently than older people).

Structure and sustainability of the new NDC scheme

The first pillar is financed on a PAYG basis but is structured on the new paradigm in social insurance – a defined contribution scheme with notional accounts (NDC).[3] Starting from 1 January 1999, part of the old-age contribution (or full contribution for those who are not members of the funded pillar) is registered in the first pillar account managed by ZUS, which accumulates a notional

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2. With the exception of those who accrue pension rights before the end of 2006.

3. For discussion on NDC systems see, for example, Góra and Palmer (2001).

capital. The capital represents the pension rights accumulated by an individual throughout his/her working career. The notional capital accumulated in the account is indexed annually to 75% of the wage bill growth. Indexation below the wage bill growth creates some space to finance the transition period, where pensions are still higher (as a result of past obligations). The NDC benefit formula is based on a standard annuity formula, where the value of the benefit depends on the notional capital accumulated in the account and the period of benefit payment. The main advantages of this approach are:

- Relating benefits to lifetime contributions.
- Higher incentives to comply.
- Higher incentives to postpone retirement.
- Automatic adjustment to demographic changes.

Currently, the contribution rate for financing old-age pensions in the public pillar is set at 12.22% of salary (19.52% for transition cohorts who did not joint the funded pillar). All workers and the self-employed are obliged to pay contributions to the old-age system. Additionally, for some periods, the contribution is financed from public sources (state budget or Labour Fund). These include periods of receiving unemployment benefits, maternity and parental leave, mandatory army service, and taking care of a disabled family member (child, parent). The wage base for calculation of the benefit is either the minimum wage or the size of received benefits.

The pension is computed by dividing the notional capital accumulated on the account by the so-called G-value – life expectancy at the time of retirement. G-values are computed by the Central Statistical Office and are equal to the unisex life expectancy (in months) at the year of retirement. The law does not allow for differentiation of G-values for any reason, such as gender, health status, place of residence, profession, etc.

Pension reform legislation includes a provision that pension benefits should be indexed at least to inflation plus 20% of real wage growth. Such benefit indexation can be viewed from two perspectives. On the one hand it helps to reduce expenditures in relation to GDP, which diminishes the gap between the expenditures and the revenues of the system. On the other, individuals with the same wage and tenure characteristics have different pensions if they retire at different moments in time. Older pensioners have lower pensions than those who claimed their benefits later. In the longer run, such a policy may cause social problems, as happened in Poland at the beginning of the 1990s and which resulted in a re-calculation of all pension benefits to reduce the above-mentioned differences.

The new pension system abolishes all early retirement privileges. All persons born after 1948 and retiring after 2006[4] will retire at the legal retirement age. However, for persons working in special conditions, special arrangements by way of bridging pensions have been proposed. The proposal was discussed with the social partners during the period 1999-2001. Currently, the new government is planning to continue work on this additional element of the pension scheme.

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4. With the exception of those who worked long enough in special conditions (20 years), who kept their right to retire earlier.

Transition to the new system

Poland decided to recognise past rights in the form of an initial notional capital, based on the value of the old-age pension accrued on the last day that the old system was in existence (31 December 1998). The initial capital is calculated to deliver the same pension benefit as the old formula (adjusted for age and contributable years),[5] as if everyone retired on the last day of the old system. The formula for the initial capital calculation is:

Initial Capital (C_0) = $P_0 * G_{62}$, where:

P_0 pension rights accrued by a person as of 1 January 1999

G_{62} unisex life expectancy at the age of 62 in 1998 (209 months)

This approach to the recognition of pension rights was adopted mainly due to the lack of appropriate individual data. In the old pension system, the Social Security Institute received individual information only upon retirement. Because most of the individual records prior to 1980 were destroyed, this method provided a way of dealing with initial notional account status. Also, it allowed for the gradual reduction of replacement rates in the pay-as-you-go system, as the initial capital portion of the notional account decreases over time. Due to difficulties in finding appropriate records, the law sets a period of five years to calculate the initial capital for all contributors in the new pension system.[6]

Figure 15.1 presents the results of the simulation of replacement rates for different cohorts. For the reduction of demographic influence, projected life expectancies as of 2050 are used. Simulations present both values of replacement rates (as per cent of last salary) for a female retiring at the age of 60 (lower series) and for a male retiring at the age of 65 (upper series). There are two variants of the simulations:

a) A worker joins the funded pillar (pillars one and two).

b) A worker stays in the NDC pillar only (only pillar one).

For the average female retiring at 60, the replacement rates gradually decline from around 50 to 30% (excluding the value of mixed pensions for cohorts retiring in the years 2009-2013) and, for the average male retiring at 65, the replacement rate falls from 65 to 40%.

As the simulations show, the decision whether to choose the funded pillar or not, under the given assumptions, has little influence on the total size of pensions.[7] The smaller pension for women can be attributed to a lower retirement age and lower participation rates.

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5. For details see Chlon *et al.* (1999).

6. Additionally, during the transition period, the first five cohorts to retire under the new system will receive their pensions according to another transition rule. Pensions granted in the years 2009-2013 will be calculated according to a weighted average of the old and new pension formula. This formula applies to those women who will not participate in the funded pillar.

7. The key assumptions are: the annual average wage growth is 4%; the annual notional accounts indexation is 3.8%; the gross rate of return in the funded pillar is 4.2%; and fees on the funded pillar equal the current average for the sector.

The PAYG system in the longer term[8]

In this section, long-term projections related to the pension system are presented. Projections are made using the Social Budget Model.[9]

While analysing the long-term impact of pension reform on the finances of the pension system, it must be realized that there is a difference between the impact of the reform on the revenues of the old-age pension scheme in the transition to the multi-pillar system and its impact on the expenditures. The impact on revenues starts immediately the funded scheme is introduced, as part of the contribution is diverted to savings. Upon introduction, the most important issue that pension systems face is financing the transition deficit. Such a deficit can be financed from current revenues of the state budget (taxes or extraordinary revenues such as privatisation assets), which means that it is financed by current tax-payers (most notably workers and pensioners). It can also be financed by issuing special bonds – in that case, the transition is financed by future taxpayers. Finally, the deficit can be financed by savings in the PAYG pension system and in such cases pensioners are burdened with the cost of transition. The way of financing transition costs has an impact on the relative wealth of various generations.

Under the reform programme in Poland the transition costs will be financed initially from privatisation revenues and from the state budget (current taxes or debt). As simulations in Chlon-Dominczak (2002) show, in longer term however, most of the costs will be covered by the reduction of expenditure made in the public (NDC) pension system.

In the case of the benefit payout phase (*i.e.* pension expenditure), the impact of pension reform starts later. The actual timing of expenditure depends on the age of the cohorts covered by the reform regulations. In the Polish case, people under the age of 50 at the time of the introduction of the reform were covered by the new system. This means that the impact of the new regulations will be observed when this group starts to reach retirement age in 2009, in the case of women and in 2014, for men. By the same token, until 2009 all pensioners will receive pensions based on the old system formula. After this date, new system pensions will begin to be granted. The transition in the pensioners' portfolio is going to take decades.

The reform of the pension system, due to the changes in the eligibility criteria and the pension formula that it introduced, is having a significant impact on the overall situation of the pay-as-you-go pension system. Firstly, as the retirement age is increased, it is expected that the number of pensioners will be lower compared to the pre-reform situation. Secondly, the replacement rate resulting from the pensions granted under the new pension formula will be lower than that in the old pension system. These changes will result in a reduction of expenditure on old-age pensions. On the other hand, the revenues of the system are reduced due to the contribution transfer to a funded tier.

According to the projections in Chlon-Dominczak (2002), under baseline assumptions, public expenditures on old-age pensions will go down from around 6% of GDP currently to around 2% of GDP in 2050. The expenditure reduction should continue until 2040 and stabilise afterwards. The deficit in the old-age part of the system, according to this simulation, should persist until 2025. Afterwards, a surplus should appear reaching 1.4% of GDP in 2050.

8. This section comes from Chlon-Dominczak (2002).

9. The Social Budget Model was prepared by the Gdansk Institute for Market Economics, in co-operation with the Ministry of Labour and Social Policy in Poland and with the ILO.

However, if all pension expenditure is taken into account (including disability and survivor pensions), projected pension expenditure will reach 9.65% of GDP in 2050. For almost the entire projection period, all pension expenditure from the Social Insurance Fund will fluctuate at a level between 9% and 10% of GDP (compared with pension expenditure in 2050 equal to 17.3% of GDP in the no-reform scenario). For the entire projection period all pension expenditure (old-age, disability and survivors) will be higher than contribution revenues, resulting in an annual deficit of around 2% of GDP.

The costs of the introduction of the funded tier are higher than the deficit encountered in the old-age pension part of the system, as can be observed in Figure 15.2. By 2005 the total deficit in the public old-age pension scheme will be lower than the amount of contributions transferred to pension funds, that is, rationalisation measures introduced in the public system (initially mostly benefits' indexation) will partially finance the transition to the funded scheme. Figure 15.3 presents the decomposition of old-age pension expenditures by the source of financing. The share of the public system (the old system and the reformed NDC one) will dominate expenditures throughout the projection period. However, the relative size of the old part will decrease. By the mid-2020s, the share of the old system as part of total pension expenditure should be less than 50% and by 2050 it should be marginal. In 2050, the bulk of pension expenditure will still be financed from the public system as by that date the funded tier will finance only around a third of pension expenditure.

There are two factors that influence the size of expenditures: the number of beneficiaries and the size of the average pension. Within the projection period, the number of old-age pensioners will increase, until it exceeds 4 million in 2020. Thereafter, a decrease in the number of old-age pensioners is expected, to the level of 3.4 million in 2035. As a result of the retirement of the baby-boomers born in the 1980s, the number of old-age pensioners will increase again to 4 million in 2050. Compared to the no-reform scenario, the number of old-age pensioners in 2050 is projected to be 6 million fewer.

The reduction in the number of old-age pensioners will be off-set by the rise in the projected number of disability and survivor pensioners, as the increase in retirement age will cause an expansion in the number of persons claiming disability pension. The results of a simulation in relation to this issue show that the number of disability pensioners is going to increase to 4.3 million (compared to 2.3 million in the no-reform scenario) and the number of survivor pensioners will exceed 2 million (which is slightly higher than in the no-reform scenario). The projected number of pensioners and the transition between the old and the new systems are shown in Figure 15.4. Pensioners receiving their benefits based on the rules of the old system will be in the majority until mid-2020s, which corresponds to the expenditure decomposition. Thereafter, the share of "new" old-age pensioners will increase. By the end of the projection period, practically all old-age pensioners will be receiving new benefits.

In the case of pensions granted under the old system, the replacement rate should decrease from the current level of more than 60% of wages to around 35% by 2050. Such an erosion is related mainly to the assumed rate of indexation of pensions, which is equal to price inflation plus 20% of real wage growth (which is currently the law as set out in the law on pensions from the Social Insurance Fund). During the first years of the projection, the reduction is smaller, as newly granted pensions influence the average level. After 2009, when pensions are granted according to the new rules, the drop will be faster.

In the case of the new system, the projected value of pensions is much lower than the value of loans provided under the old scheme. Lowering the value of benefits by making them actuarially neutral was one of the goals of the reform plan. Such a policy, however, may lead to increased poverty among pensioners. As a result, savings in the pension system would be accompanied by increased

expenditure on social assistance for pensioners. Thus, in the future, a balance between the macroeconomic stabilisation of the pension system and providing pensioners with decent income should be sought.

The complementary role of other pillars

In this section the structure and performance of the two remaining parts of the pension system is described. It includes the mandatory funded pillar (the so-called second pillar) and voluntary funded plans, sponsored by employer – employee pension plans, which represent a part of the third pillar of the new pension scheme in Poland and which is regulated by the law on employee pension plans.

Second pillar

The second pillar is based on savings placed in obligatory open pension funds. The contribution rate to the second pillar is equal to 7.3% of a worker's wage. Funds are privately managed and the contribution is invested into financial market instruments. Pension funds in Poland are set up in the form of private joint-stock companies. They are managed by separate entities – Pension Fund Societies (PTEs), which are also private joint-stock companies. Institutions that are shareholders of the PTEs are usually financial market institutions (such as banks or insurance companies), both Polish and international. Regulation of the funded pillar in Poland was aimed at creating a transparent system, where pension savings are separated from the assets of managers and cannot be misused in any way. Pension funds and pension fund societies are also supervised by a public institution – the Superintendency of Pension Funds (UNFE). All its regulatory functions are geared towards protecting members' interests. In its activities UNFE co-operates with other governmental institutions, such as the National Bank of Poland, the Social Security Institute, the Polish Securities and Exchange Commission as well as employers' organisations and trade unions.

Each PTE can manage only one fund. It is important that pension funds and pension fund managers are separate legal entities. Such arrangements allow for a clear distinction of the assets belonging to each pension fund, and which are owned by the pension fund members. After retirement, according to the reform programme, the retiree will be required to buy an annuity. Annuities are to be provided by specialised annuity companies.[10] According to estimates, for the average wage earner, the pension from the funded pillar (under the assumptions shown in Figure 15.1) can range from 10% of his/her final salary (for persons retiring at age 60) to 13% (for persons retiring at age 65) in the case of persons who start contributing under the new regulations.

The guarantee system in Poland for second pillar funds includes the following elements.[11]

- Regulations on investments – selected financial instruments and maximum limits on investments.

- Separate custody of a pension fund's assets by large banks operating in Poland.

- Requirement of a minimum rate of return, which cannot be lower than half of the average rate of return for the pension fund market (calculated quarterly for the preceding 24 months).

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10. According to the draft annuity law submitted to the parliament. At the time of writing, the parliamentary debate on the law was not finished and the final solution may differ.

11. For a full description see Chlon *et al.* (1999).

– Reserve fund (1.5% of a pension fund's assets), which is activated in the case when the investment return of a pension fund is lower than the required minimum.

– Guarantee fund, financed by all PFS, managed by the Central Depository. If the PFS does not have enough sources in its reserve account and from its own capital to pay the deficit, member's savings are replenished from the Guarantee fund. Total assets of the Guarantee fund should not exceed 0.1% of the total assets of the pension funds sector.

Annual revenues of the sector are projected to increase from currently about 1.5% of GDP to almost 2% of GDP after 2020. At the same time, expenditures will be much smaller, especially in the first 20 years, when they should not exceed 0.5% of GDP annually. A significant increase of expenditures is projected after 2025, when most of the pensioners start to receive their funded pensions (Figure 15.5).

In 2050, the projected size of assets accumulated in the funded tier should reach the level of 180% of GDP.

Third pillar

The pension legislation envisaged the third pillar is voluntary, based on individuals' savings or employer-sponsored programmes. During the reform preparation, the latter – so-called employee pension plans – received the greatest attention. The law envisages that employers may sponsor such plans for their employees in one of the following forms:

– An employee pension fund.

– Agreement with an investment fund.

– Mutual insurance; or

– Agreement with an insurance company.

Employers may pay up to 7% of salary to such a programme. The contribution is taxable, but it is not subject to a social security contribution, which creates some savings for both employers and employees. Savings accumulated in such plans may be withdrawn only after a participant reaches the age of 60 (regardless of gender) or earlier, if he or she becomes disabled.

Pension plans are registered and supervised by UNFE. As of the end of 2001, there were more than 100 employee pension plans registered with UNFE. Those plans cover a very modest share of the labour force in Poland. Employers' interest in establishing employee pension plans is limited due to several factors:

– Relatively complicated registration procedures.

– Already high labour costs.

– The difficult situation in the labour market and the lack of incentives for employers to establish long-term plans with uncertain prospects for the future; and

– No fiscal incentives.

Efforts are being made to enhance the development of the third pillar, mainly by simplifying the registration procedures.

Implementation of the reform

Reform implementation and the individualisation of contribution payments created a challenge for all the institutions involved – ZUS, employers and banks. The short time after the enactment of the reform legislation and its implementation (approximately a couple of months) and delays in the development of ZUS IT systems, made the implementation process even more difficult.

First experiences revealed many problems in the proper identification of payments. As a result, changes in the law were necessary. The first test of the new system – the transfer of the first contributions to private pension funds – showed that only 5% of payments had been properly identified.

In the course of 1999-2001, the social security law was amended 17 times. Some of the amendments were related to the development of legislation in other sectors and some were initiated by the Ministry of Labour and ZUS in order to solve problems and issues that emerged during the implementation.

Legislative changes during this period included, among others:

- Improvements in the identification of insured people by obliging employers and pension funds to use two identification numbers: PESEL (a registration number) and NIP (a tax number).
- The introduction of an annual report for all employers in 1999-2001.
- A shift in the dates of contribution payments and reports delivery. The change allowed for partial elimination of a "peak time" in the delivery of reports to ZUS offices and permitted more time for document correction and analysis.
- The introduction of a penalty fee for those who made mistakes in monthly reports or bank documents.
- The stipulation that employers who employ more than 20 staff should submit data electronically, as electronic transfer generates the smallest number of errors.

Amendments to the legislation also postponed the deadline for sending the first report on their accounts to insured persons. Under the reform, each insured person must receive an annual statement of his or her notional account. As the implementation of the computer system was delayed, the date for issuing the first such statement was moved to August 2002. Changes in the legislation were accompanied by administrative reforms in the Social Security Institute.

The way ZUS was organised and managed had to be improved in order to keep up with the changes introduced by both the social security and the health insurance reforms. Although much had been done in order to prepare ZUS for its new role (mainly preparation to service the second pillar private pension funds and health care funds), more profound changes were needed and quickly. In order to prepare ZUS for change, a strategic plan was developed by the end of 1999.

The development of the Strategic Plan was facilitated through a series of sessions involving all members of ZUS top management. The participants of the strategic planning process agreed on five strategic goals:

1) To improve ZUS performance in the realisation of its statutory tasks.

2) To identify and improve upon customer satisfaction.

3) To increase internal efficiency.

4) To enhance effectiveness of human capital in ZUS.

5) To increase ZUS ability to adapt to change.

Throughout the project, much emphasis was placed on evaluating the efficiency of operations of ZUS local branches. The recommendations that resulted from the analysis of such evaluations helped develop a new organisational structure within ZUS and improve the way the institution operated.

Development of the computer system in ZUS

After the implementation of the reformed system and of the obligation to transfer part of the contributions to open pension funds, an interim IT system was initially created so that monthly information could be processed in a simplified way. However, this system was not sufficient to support either the correction of errors or the maintenance of the individual accounts. After 2000, most efforts were focused on completing the main component of the IT system, namely the Registry of Accounts and Funds (SEKIF). At the end of 2000, the mainframe computer was successfully installed in ZUS. From August 2001, all current contributions were registered on individual accounts on the final platform (however the interim system was still used to transfer second pillar contributions). The IT system began operating in its final form from June 2002, when the final platform achieved a greater level of efficiency in information processing than the interim one.

Currently, the main focus in the development of the IT system is on improvements in the quality of the data in the monthly reports and on processing documents for 1999-2001 so that contributions are cleared of errors and registered on individual accounts. This should also enable ZUS to assess arrears in the pension funds.

Initial capital

In the second half of 2000, after the relevant decree came into force, ZUS started to collect the information necessary to calculate the initial capital, representing accrued pension rights on the notional accounts of insured persons. This requires gathering necessary historical data on wage and employment history for all persons covered by the pension reform.

The process is complex and requires action not only by ZUS, but also by employers, who need to submit necessary documentation, and by insured persons who are obliged to collect documents from their previous workplaces. The law requires that the process should be finished by the end of 2003.

Contribution transfer to second pillar

Currently, according to ZUS estimates, 80% of contributions are transferred to pension funds. The rest is not sent on, mostly due to lack of accompanying information that would enable it to be appropriately transferred. The other problem is that of dormant accounts, where the members of pension funds are either not insured and do not pay contributions or are not properly identified in the ZUS databases. For those persons no contribution at all has been transferred to pension funds. As of

the end of 2001 some 20% of accounts had not received any contribution. This share varies from fund to fund, ranging from 8% to 77%.

In the period of 1999-2001, more than PLN 18 billion of contributions were transferred to pension funds. The transfer was smallest in 1999 (almost PLN 2.3 billion). In 2000 it was more than PLN 7 billion and in 2001, almost PLN 9 billion. In the following years the transfer should increase slightly with the growth in wages and in the number of pension funds participants (Table 15.1).

It was assessed by ZUS that at the end of 2001, the total debt to pension funds resulting from delays in contribution transfer was more than PLN 7.3 billion, of which contributions accounted for PLN 5.5 billion and interest for PLN 1.8 billion. It is planned that the arrears owed to pension funds will be financed in the form of special bonds issued by the state budget.

Conceptual work on missing components of pension reform legislation

Bridging pensions

The Ministry of Labour and Social Policy is working on the draft legislation for bridging pensions, compensation mechanisms and retraining that is intended to replace the early retirement privileges existing in the old pension system. The work of the Ministry is based on the report of the Medical Experts Committee for Assessment of the Rights to Lower Retirement Age of Persons Employed in Special Conditions or Special Character. The Committee specified types of occupations that would enable persons who currently perform this work to draw a special type of benefit called a bridging pension. Based on the Committee report, the Ministry of Labour submitted the bridging pensions law proposal to the social partners in 1999.

Under the government proposal, bridging pensions would be financed by the state (for the period until the bridging pensions law is legislated) and employers (for the period after the bridging pensions law is enacted). Individuals currently working under special conditions will have a right to a bridging pension. Contributions would be set and collected by the Bridging Pensions Agency, which is going to manage the Bridging Pensions Fund (FEP). External asset managers, selected by tender will manage the assets of the FEP. The Bridging Pensions Agency will also pay benefits. Those persons that had early retirement rights under the old regulations and are not covered by a bridging pension will receive compensation in the form of increased initial capital in their pay-as-you-go pension account.

The conceptual work on the bridging pension is continuing and within the next couple of years the legislation should be completed.

Annuity legislation

The accumulation phase of participation in the second pillar is fully regulated by laws already introduced. The contributions for the second pillar part of the old-age pension are paid into open pension funds that are managed by pension societies through the financial markets. However, regulations concerning the benefit phase are incomplete. There are three possible options for providing annuities currently being discussed:

- Specialised annuity companies – privately managed and competing with each other. The first government proposal was based on this idea. However, after further consultations, the government had reservations about this arrangement because of the relatively high costs and difficulties in calculating annuities based on unisex life expectancy (which was preferred by all political parties in the previous parliament).

- Allowing life insurance companies to deliver annuity products. Such a solution would mean relatively low start-up costs and combining reserves for life insurance and annuity products. However, it is still relatively costly and leads to a situation where the mandatory pension system loses part of its transparency.

- One annuity company pooling risk and contracting out management of assets based on investment performance. Such an option allows for better risk pooling and relatively easy use of unisex life tables. It would also keep the costs low. However, it does not allow individual choice and might be subject to political risk.

The new system covers workers born after 31 December 1948. This implies that the first annuities will paid out from 1 January 2009 (women's retirement age is 60). Men will start retiring from 1 January 2014. Whatever the option chosen, appropriate institutions will need time to "warm up". Although there is still time to design and set up one or more institutions to provide annuities, the appropriate legal measures should be taken sooner rather than later.

National actuary

The main goal of the pension reform in Poland was to create a pension system that is financially stable in the long run. Such a goal cannot be achieved through one measure alone – a change in pension legislation. Thus, the establishment of a National Actuary, whose responsibility would include the provision of long-term actuarial estimates of the revenues and expenditures of the social security system, seems to be crucial. According to the original idea, any change in the legislation affecting the financial situation of the social security system would have to be accompanied by a report from the National Actuary. The Actuary would also publish regular reports on the long-term outlook of the social security systems and would serve all public institutions in matters related to actuarial analyses, similar to the Government Actuary in the United Kingdom. The National Actuary would head a separate Agency. This institution should be fully independent and all its reports should be based on professional assessments made by the National Actuary. Therefore, the post of National Actuary should be given to a person with the highest professional qualifications.

Development of the mandatory funded pillar of the system

As many as 21 pension funds started their operations in Poland in 1999. By the end of 2001, 17 pension funds and PTEs remained in the market, and four were liquidated as a result of merger and acquisition processes. Total assets of pension funds reached the level of PLN 20 billion (around USD 4 billion), which was almost double the figure for the year before (see Figure 15.6).

There were 11 million registered members of pension funds. For more than 9.5 million of these, at least one contribution was transferred. Annual inflow of contributions (as projected for 2002) is around PLN 11 billion(about 1.5% of GDP).

The market is concentrated. The share of the three biggest funds measured as a share of the total assets amounts to 65% and measured as a share of the membership – exceeds 55% (Figure 15.7).

The investment portfolio more or less stabilised after the fourth quarter of 1999. On average slightly above 60% of assets is invested in government bonds, while around 30% is invested in assets. The remaining share is invested mostly in treasury bills and other instruments (Figure 15.8).

Performance during the first three years of operation shows that pension funds in the first two years outperformed the benchmark, while in 2001 they under-performed. Generally, the performance

in 2000 and 2001 was seriously influenced by the worsening situation of the financial markets, especially in 2001, when the Warsaw Stock Exchange bluechips index (WIG-20) was reduced by a third.

The performance of pension funds in the first three years, combined with the structure and level of pension fund charges, resulted in negative net rates of return for their first two years of operation. However, in the following years, as charges in relation to assets will go down, members can expect positive returns on their pension fund savings (Table 15.2).

Summary

The implementation of the pension reform in Poland provides valuable lessons for other countries. The reform concept envisaged the creation of a system that would be financially sustainable and transparent. The most important feature of such a system was the creation of a very strong link between contributions and pensions – both within the PAYG and funded pillars of the new multi-pillar scheme.

The first months of implementation showed that not enough effort was put into the development of a proper administration for the new scheme. Individual accounts were not created until mid-2002 and only a fraction of contributions was transferred to open pension funds. The funded pillar (despite lower transfers) developed more smoothly. Moreover, massive advertising and sales campaigns by pension funds left an impression that the new system would provide people with significantly higher pensions that currently paid.

Such an impression, as projections show, might be misleading, as the contributions paid into the system would grant benefits, which in relation to wages, would be lower than currently paid. Only if wages increase significantly will future pensions be higher in real terms than current ones.

The experience of Poland shows that reforming the pension system is not a one-step action. Rather it is a long process that requires a lot of preparation and extensive monitoring even years after the implementation of the change. For the success of this process all the necessary components – preparation of the concept, consultations, legislation and finally implementation – must be carefully planned, and all possible scenarios have to be considered.

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Table 15.1. Transfer of contributions to open pension funds

	Contributions and interest	Contributions	Interest	Amount of transferred contributions	Average contribution per pension fund member	Average salary base per pension fund member
	In PLN million					
Total	**18 595,91**	**18 502,01**	**93,90**	**168 790 965**	**109,61**	**1 501,57**
1999	2 285,54	2 262,67	22,86	23 346 432	96,92 zł	1 327,63 zł
2000	7 603,49	7 586,39	17,10	70 517 118	107,59 zł	1 473,73 zł
2001	8 706,88	8 652,94	53,94	74 927 415	115,49 zł	1 581,98 zł

Source: ZUS.

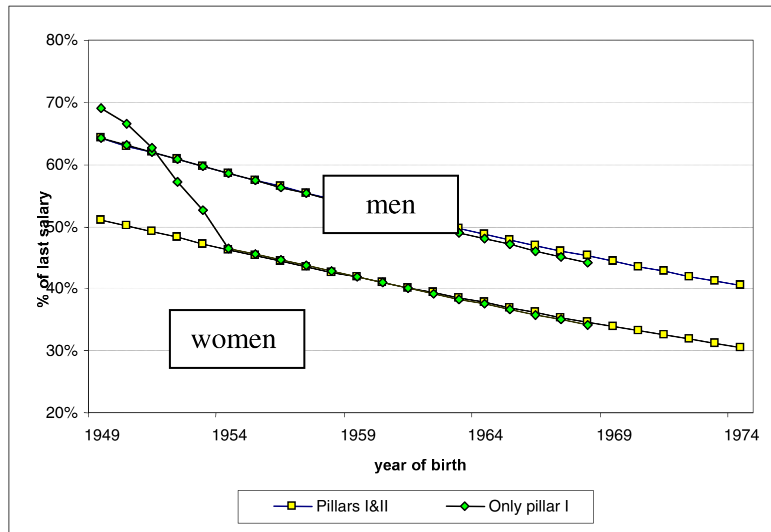
Table 15.2. Performance comparison of pension funds in Poland

	1999*	**2000**	**2001**
Benchmark**	5.31%	7.40%	8.21%
Weighted average	15.09%	13.03%	7.06%
Mean	15.86%	14.27%	4.85%
The best pension fund	20.50%	18.30%	10.03%
The worst pension fund	12.40%	765%	-4.26%
WIG-20 Index	17.08%	3.44%	-33.47%
Inflation	5.10%	8.61%	3.65%
Fixed Income Benchmark	1.83%	10.03%	23.64%

* 20 May-31 December 1999

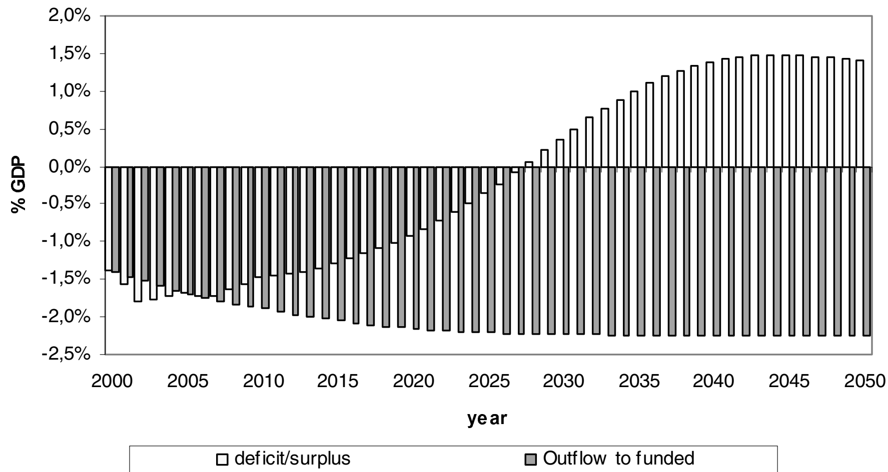
** Benchmark – 30% equity, 70% fixed income

Figure 15.1. Simulated replacement rates for birth cohorts 1949-1974



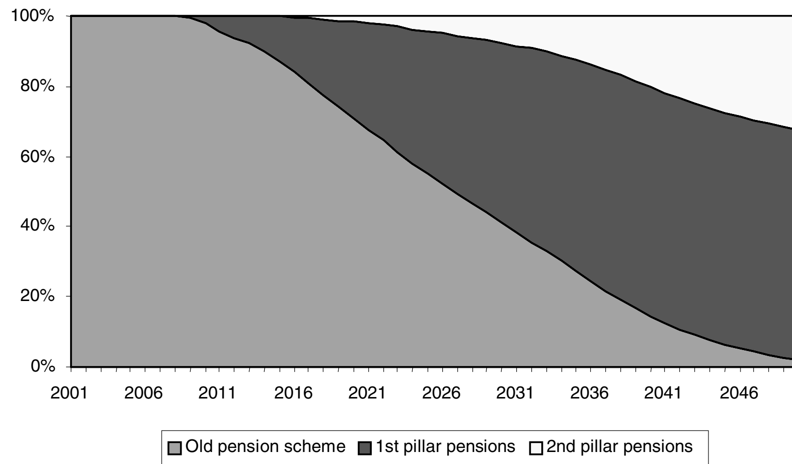
Source: Author's calculations.

Figure 15.2. Outflow to funded tier vs. deficit/surplus in pay-as-you-go



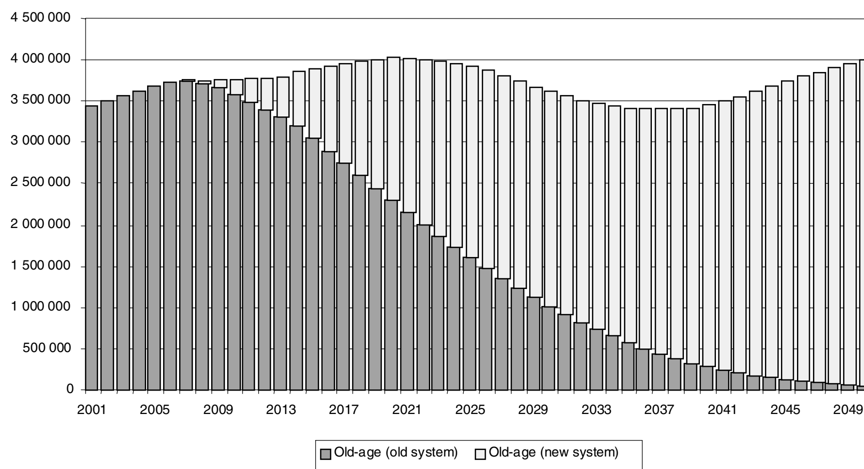
Source: The Gdansk Institute for Market Economics, Social Budget Model, Model after Chlon-Dominczak (2002).

Figure 15.3. Financing of pensions, 2000-2050



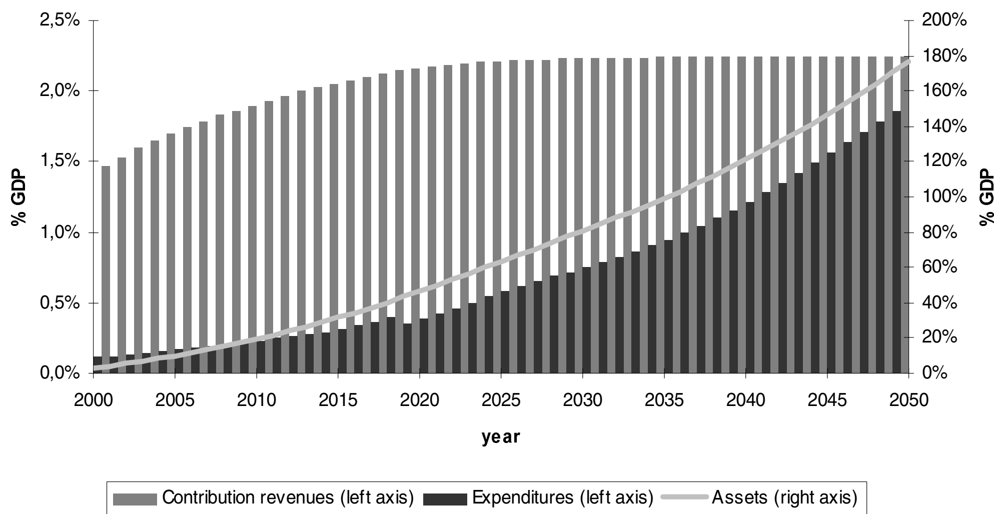
Source: The Gdansk Institute for Market Economics, Social Budget Model, Model after Chlon-Dominczak (2002).

Figure 15.4. Projected number of old-age pensioners, 2001-2050



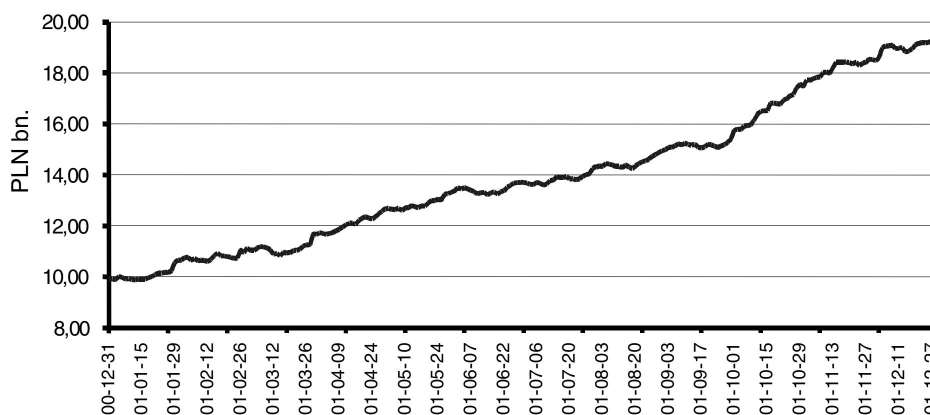
Source: The Gdansk Institute for Market Economics, Social Budget Model, Model after Chlon-Dominczak (2002).

Figure 15.5. Revenues, expenditures and assets of pension funds, 2000-2050



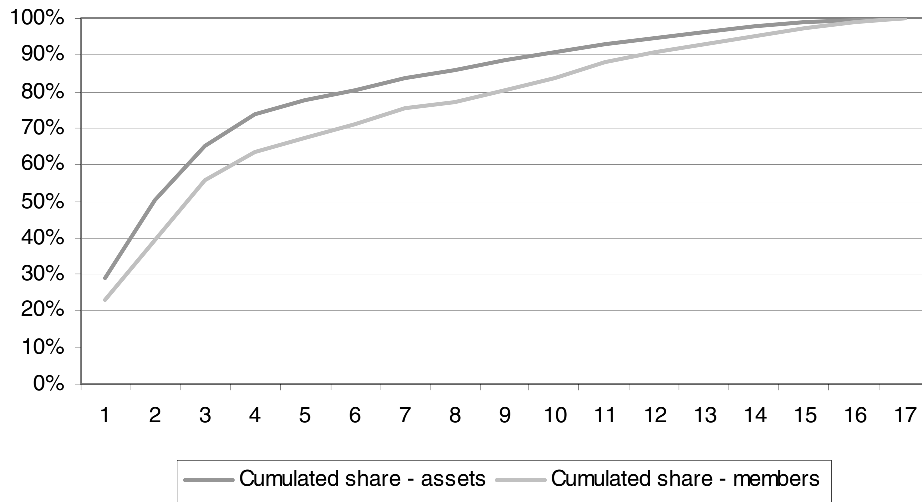
Source: The Gdansk Institute for Market Economics, Social Budget Model, Model after Chlon-Dominczak (2002).

Figure 15.6. Net assets of open pension funds in 2001.



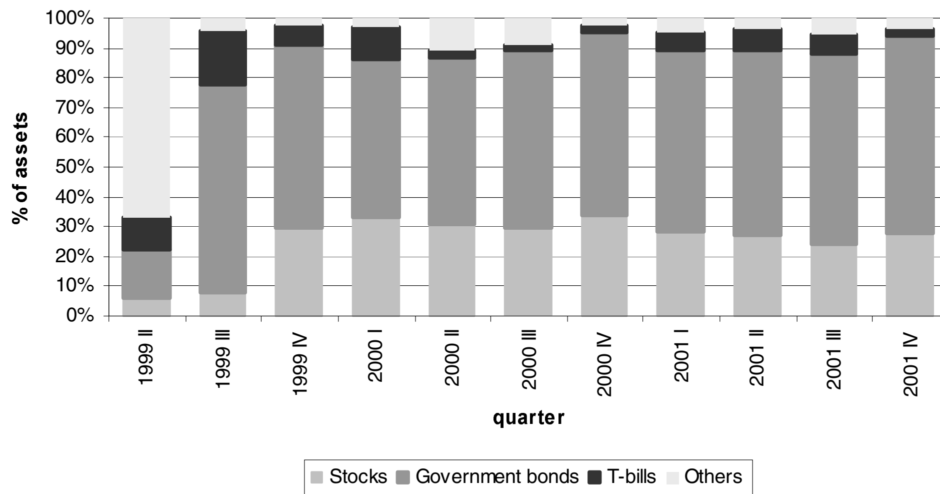
Source: UNFE

Figure 15.7. Concentration of pension funds market



Source: UNFE, data as at 31.12.2001.

Figure 15.8. OFE's investment portfolio structure, 1999-2001



Source: UNFE.

Chapter 16

SOME PRACTICAL ISSUES IN THE HUNGARIAN PENSION REFORM

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Introduction

In practice, people often mean only one part of a pension system when discussing pension reform, that is, the changes made to a social security system. However, a systematic approach requires a broader discussion.

A pension may be defined as the regular income granted for life after retiring from work at a certain age, on the basis of rights obtained during the years spent at work. But in a broader sense, any income can be considered as a pension if it ensures a certain standard of living in old age, the inactive life phase. Thus, all institutions that provide such pensions can be considered as elements of the pension system.

One of the most important features of the Hungarian pension reform was that new institutions were established to provide pensions supplementing and complementing government social security pensions. In the past, the only institution providing pensions was the so-called social security institution. But the Hungarian reform has created what are essentially new institutions. These are private organisations, operating on a defined contribution basis. This form of individual provision as well, as the concept of pension planning, was totally new in Hungary. As a result, the very first reactions to these new institutions were negative, as people were afraid of losing the stable state provision, which had provided an income almost independent of an individual pensioner's past employment record. The first task for the new institutions managing pension funds was to gain people's confidence.

Together with these new pension institutions, a three pillar system was built up in Hungary. The first pillar is the pension granted by the social security agency. The second pillar consists of pensions paid by mandatory private pension funds that are built up from mandatory contributions set as a proportion of wages. The third pillar includes pensions that are provided on the basis of pension fund contributions or insurance fees, paid voluntarily by the insured person or their employer.[1]

1. The usual meaning of the three pillars of state/occupational/personal pensions is different from the Hungarian interpretation of the three pillars. Sometimes this has resulted in some misunderstanding, as the second pillar in Hungary means the private mandatory system, which is different from the more traditional meaning of the second pillar in Europe, namely occupational pensions.

This paper deals with some aspects of the private pension system as a whole, but of course the mandatory system is its main focus.

The pension promises in the mandatory system

There was extensive debate, motivated by different political views, on the reform of the mandatory system. Many arguments were made for and against the reform, and many details of the final legislation were influenced by these debates.

The answer to the question whether it is worthwhile for individuals to join the new two pillar system (that is, to join the second pillar as well as belonging to the first) was given by the citizens of Hungary, of whom a far higher proportion voted to join than was initially projected. But this vote was not really consciously for the new system, but rather against the old one. The low level of state pensions, the lack of transparency, and some types of social injustice in the old system were widely known at the time of the vote.

Taking into consideration the pension promises of the two different mandatory systems, it should be realised that the advantages of the new system can only occur where there is good investment performance, providing a positive average real rate of return. Thus it is not clear that all those who joined the two pillar system will eventually receive better pensions than those who remained in the state system alone.

The development of the private pension fund market

When voluntary pension funds began to operate, the majority of interested parties were hesitant. This may have been due either to lack of information or because of distrust, but in essence the majority of people did not really know how to take advantage of this new institution. Even those with available disposable income became interested in investing in these pension funds only slowly. Only a few corporate employers made strategic decisions to supplement employees' pensions, as the uncertainties of these years of change meant that the focus of corporate decisions was not on long-term strategic considerations. Thus, the number of members of voluntary funds increased only gradually. In practice, only the opportunity for tax savings motivated the interest of employers and employees in voluntary pension funds.[2]

The establishment of mandatory private pension funds from January 1998 was a real turning point. The introduction of the new mandatory pension system raised new issues such as individual responsibility, contributing to a pension that was not guaranteed by the state and the potential risks to living standards in old age. The creation of the second pillar forced the majority of employees – those below retirement age − to decide within a very short period of time (from a historical point of view)[3] whether to enter the new, mixed insurance system or to stay in the traditional social security system. And if they decided to enter the former, they also had to decide which mandatory private pension fund they wished to join. Young entrants also faced this latter decision, as although the act made entry

2. Between 1995 and 1999, 50% of the contributions (up to a maximum of HUF 200 000 per year) paid into voluntary funds were tax deductible. This meant a net tax saving for people paying membership fees, since the marginal tax rate was lower, even in the highest tax bracket, than the amount of tax relief. In the first two years, even more favourable tax laws were in force. After 2000, tax relief decreased to 30% of payments, but the employer's contributions became tax-free up to a determined amount.

3. The law only provided employees below retirement age with the opportunity of entering one of the private pension funds until the end of 2000.

mandatory for them, the freedom to choose which fund to join remained. As a result, most employees were forced, at some level, to deal with the issue of their pension provision.

Many people were afraid that the development of mandatory private pension funds would slow down the growth of voluntary funds, or even undermine them. But this did not happen. Indeed, the development of voluntary funds was further accelerated by the improvements in mandatory private pension funds, since it then became clear that voluntary funds were not only a means of tax saving. In fact, this concern could not even be justified theoretically by the voluntary funds, since the target groups of the two different types of pension funds were also different. Mandatory private pension funds are primarily an alternative approach for younger people, while entering voluntary funds can be a form of saving worth considering by individuals who are closer to retirement.

By the beginning of 2000, the Hungarian pension fund business had developed into a real industry. Figures show convincingly that the story of the Hungarian pension fund "industry" is a success. By the end of 1999, of the almost 4.1 million economically active members of the Hungarian population, more than 2 million had entered into one of the 32 registered mandatory private pension funds. The number of members of voluntary private funds also exceeded 1 million. By the end of 1999, the assets handled by private funds were near to HUF 250 billion. It is also significant that by 1999, pension fund savings represented 5% of total household savings, while this figure was less than 1% in 1996.

High levels of concentration can be observed in both the mandatory private pension fund and the voluntary fund market. Concentration is especially high in the mandatory private pension fund market. According to data for the end of 2001, of the nearly 2.25 million fund members, about 90% belong to the largest six funds. Membership of each of these funds has reached 100 000 persons, and these six funds possess assets that represent about 80% of all mandatory private pension fund assets.

Concentration is somewhat smaller in the voluntary fund market, but the concentration process is becoming increasingly marked. Of the approximately[4] 240 voluntary funds registered at the end of 1999, the 18 largest had almost 72% of the membership, and the 27 largest funds at the end of 1999 had nearly 70% of the total assets. At the same time, of the almost 300 voluntary pension funds established in the last five years, fewer than 150 funds remained by mid 2000, and fewer than 110 by the beginning of 2002. Since fewer than 5% of the established voluntary funds had a membership of 5 000 persons or more, in many cases the termination of funds arose from basic economic pressures. But the evolution of the current size structure cannot only be accounted for by this factor alone.

The information gap

In the process of Hungarian pension reform, probably the biggest mistake was that the state failed to fulfil its obligation to inform citizens fully about it. There were several attempts at organising appropriate information campaigns, and different types of support were available for these. Still, these campaigns were either inefficient, or information provision initiatives were simply not implemented. As time passed and the deadlines determined by the law expired, citizens interested in ensuring their pension security were left to make their decisions with inadequate information. Indeed, as the intentions of the government itself, in respect of pension reform, were contradictory, uncertainty amongst its citizens as to the appropriate course of action to take only increased conflicting political interests made the process of pension reform – of which people were already distrustful – less and less

4. The exact number of voluntary funds at a given date cannot be precisely determined, partly due to fusions and mergers in process, reported or under preparation, and partly because of the existence of funds that are not yet actually operating or else have gone out of operation.

credible. It was obvious that the nature of the communication about this subject by the government with its citizens was inappropriate. It was not even clear whether the government wanted the pension reform to be successful or not.

Naturally, the private pension institutions quickly recognised the opportunities inherent in providing information, and the leaflets they published tried to assist an understanding of the new system. But the quality of these leaflets varied widely, since a fund wishing to interest people in becoming its members with – from a marketing point of view – well targeted, professionally produced materials, needed quite a large amount of money. This was the initial point at which the unequal opportunities open to different funds became increasingly clear. Funds with a bank or insurance company background had an almost overwhelming advantage in preparing publicity material and in getting this to potential fund members. Eventually these funds filled the information gap that would have been a serious problem for individuals who were forced to make decisions about their pensions.

It must be asked whether, if information with the necessary detail had been provided by the government what chances of success would the smaller funds, principally the ones with an employer background, have had? The current level of concentration of pension assets could be justified economically if pension funds organised on market principles and those organised on non-market principles had started up on an equal footing. It cannot be known whether an institutional structure providing more efficient member protection could have arisen if all the concerned parties had initially received the necessary information to enable them to understand the opportunities of the pension fund system.

What is a Hungarian "pension fund"?

In Hungary it has been possible to found and operate pension funds since 1993. Initially, the so-called voluntary mutual pension insurance funds could be formed. Members could enter these pension funds – as their name shows – voluntarily, and they could also determine the amount of contributions – called membership fees – themselves. The legal background of their operation was regulated for the first time by Act No. XCVI. of 1993.[5]

The 1998 pension reform established a new institution within the mandatory pension system, which is called a mandatory private pension fund.[6] The operation of mandatory private pension funds is the same as the operation of voluntary funds in many respects, but there are also significant differences. One of the main differences is that in the case of mandatory private pension funds, it is not the member (or the fund) who decides the amount of the contribution – that is, the membership fee – they wish to pay, but it is prescribed for them by the law. The other important difference is that mandatory private pension funds do not add to or replace, but work together with the pension provided by the social security system. Thus, those Hungarian citizens entitled to asocial security pension, and who have entered into a mandatory private pension fund, will receive a lower social security pension – since they have paid lower contributions – than those who retire as non-mandatory private pension fund members.[7]

5. Since 1993, the law and the related regulations have been modified several times, only partly due to the need to fine-tune the legislation. Yet the most important aspect of pension legislation should be its long-term stability.

6. Act No. LXXXII of 1997 on Private Pension and Private Pension Funds was accepted by parliament on 15 July 1997.

7. The amount of social security pension in the new pension system is calculated by using the amount of the average income as the basis for contributions multiplied by the actual length of time spent in

However, ordinary individuals are totally confused by the pension concept. Phrases such as "voluntary mutual insurance fund" and "mandatory private pension fund" have caused quite a lot of confusion in themselves.[8] At the time of the introduction of the 1997 Act, there were few people who could differentiate between pension insurance[9] traded on the life insurance market and the services of pension funds. This situation has not changed much in the last seven years, especially as most insurance companies sell both pension insurance products and pension fund services at the same time. This is quite reasonable, since the purpose of pension funds is practically the same as that of pension insurance, and they are really only different organisations with the same objective, namely the implementation of individual income provision for old age.

A pension fund, however, (and here this means a private pension fund established as such by the law) is only one of the possible institutions for implementing individual provision of old-age security. But it cannot be said to be the only institution catering for individual provision for an old-age income, as has happened in Hungary. Moreover, it is not clear that this kind of individual provision should be implemented by institutions such as these regulated private pension funds. What would have happened if this new institution had not existed? It is possible that the already existing money market institutions would have undertaken the management of pension savings – with incentives from tax relief – without being forced to establish pension funds that comply with the legal requirements laid down by the government. Looking at the situation in this way, the "concentration" experienced in the Hungarian pension fund market can be understood as the financial institutions, already in the market, recapturing the pension savings market which was forcibly taken away from them by the imposition of legal regulation.

The pension fund is actually a pension fund managing institution, the owners of which are the members themselves.[10] But this is not clear in the current situation. The background institutions of the leading pension funds, the banks and insurance companies, behave exactly like pension fund managers. That is, they undertake the responsibility of managing savings provided for pension purposes as part of their basic commercial activities, which they pursue in order to make a profit for the financial institution's owners. Of course, this is not necessarily contrary to the interests of the members. The business reputation of the background institution can ensure that a basic security exists for members' investments. In addition, members may obtain a direct advantage from the fact that, in conditions of significant market competition, maximising yields can be the strongest way of retaining members, and thus the background institution may direct proceeds arising from other sources, towards the pension fund.[11] But if this competition disappears, for example as the result of a fund cartel, the

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service multiplied by a pension multiplier. The pension multiplier is 1.22 in case of private pension fund members, while it is 1.65 in all other cases. Consequently, private pension fund members receive a pension from social security that is 26% lower than is the case for non-members of such private funds.

8. Even the English translation of the Hungarian legislation is somehow confusing. The Hungarian private pension institutions are called "pension funds", but these are not purely a "pool of assets" as is commonly meant by the expression "pension funds".

9. After the appearance of pension funds, the character of pension insurance products offered by insurance companies became in many respects more similar in character to the services offered by pension funds.

10. Probably the "mutual" attribute appearing in the title of mutual funds refers to the fact that the operating principle of Hungarian pension funds most resembles the Anglo-Saxon "mutual funds", that is, pension funds operated on the principles of mutuality.

11. This can happen in a way that ensures support for the operation of the pension fund from its own profits, but it is also possible that at the time of allocation, the fund assigns investments with more

business interests of the background institutions may then be their major concern that could adversely affect members' interests.

This is the reason why it should be considered whether large financial institutions should be allowed to manage pension funds in exactly the same way as they do their subsidiaries. This is because in doing so, they tend to ignore the fact that the Hungarian legislation on pension funds defines different ownership structures in Hungary for such funds compared to their other subsidiaries.[12]

Raison d'être of small pension funds

At the time of the creation of pension funds, a relatively large number of mainly small pension funds were founded, the raison d'être of which caused much disagreement among professionals. One view is that it was wrong from the start to allow the establishment of small pension funds.[13] Some argued from the beginning that proper business operations are impossible with memberships smaller than a certain size, and they pointed to the dramatic decrease in the number of pension funds established during earlier attempts to found such institutions. The most serious argument against small pension funds was the uncertainty of their long-term operation. These funds – practically without exception – are heavily dependent on particular individuals and can get into deep management crises after a key person's position is terminated. Moreover, the aspects of the activities of pension funds which resemble those of financial institutions, the professional skills needed and the strict customer protection requirements, all indicated that the institutions established for the management of pension funds cannot be operated in a quasi-amateur way. And small organisations cannot really ensure the necessary level of professional expertise.

From this perspective, it is understandable that certain pressures have been exerted on small funds almost from the beginning, even by the state supervisory authorities. Employers in selecting funds have excluded small funds operating without background financial organisations, and they have chosen from the funds with a bank or insurance company background as they considered this more appropriate.

Nevertheless, some organisations did take a different approach to creating pension funds. Several were founded that did not target market-based growth. These were and remain funds established with a few tens of members that considered the foundation of an independent pension fund the best tool to achieve a kind of specific community interest. In most cases, these funds were established upon the initiative and with the support of an employer, but there are examples where geographical communities based on municipalities – by taking the text of the act seriously – established small pension funds. These fulfilled the technicalities of operating as such by contracting with professional organisations to undertake these functions. These funds were intent on independence and their founders were primarily motivated by their view that the fund was not a "factory" that had to operate economically, but an interest enforcing organisation that ensured its ability to operate by the manner in which it organised its operations. But in order to achieve this, it was essential to have an appropriate

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favourable yields to the pension fund reserves. In an extreme case – especially in the initial periods of gaining market share – the published yields of certain pension funds with a financial institution background were significantly higher than the market average, while the efficiency of other funds managed by the same background institution lagged behind the market level.

12. Of course, this behaviour by financial institutions does not call into question the ownership of individual pension capital, but only members' autonomy, which is defined by the Act.

13. The Act allows the foundation of a voluntary pension fund with only 15 people, while in the case of private pension funds, the minimum membership is 2 000.

economic environment where business enterprises, which could offer expert services to these small funds at competitive prices, existed. However, the change of the market climate did not favour these small funds which eventually – as it has been indicated by the figures mentioned above – came to represent a smaller and smaller share of the pension fund market.

It is not impossible that small and medium sized funds will effectively disappear from the Hungarian market in the future. According to some more realistic expert estimates it is expected that, apart from the four to five dominant pension funds covering 85-90% of the market, a maximum of 10-12 mandatory private pension funds and about 70-80 voluntary funds will remain, while the others will sooner or later cease operating.

But before saying a requiem for these small funds, their undoubted merits must be appraised. The heroism accorded to pioneers cannot be taken away from them, as they contributed significantly to the success of the pension reform. Due to the transparency which small operations have, they assisted in exposing the many weaknesses in the pension fund laws and they were most effective in finding efficient solutions to these. Moreover, there were people in all of the small funds who learned the business of how to operate funds and, as a result, a group of professionals has been developed with strong skills in pension fund management.

It was fortunate that it was possible to establish small funds in the early phase of the operation of private pension funds. The small voluntary funds were able to be experimental workshops where many different aspects of the private pension system could be worked out. The author is convinced that without them, the introduction and unprecedentedly fast growth of mandatory private pension funds would have been impossible.

Operation of pension funds

In order to undertake the activities necessary for the operation of pension funds such as accounting, financial, and actuarial professional functions, administration services (accounting and customer account registration), and investment activity and asset management, several organisational solutions evolved. The simplest organisational structure is represented by those funds that provide nearly all the required operational activities themselves. This means that the pension fund concludes contracts only for banking and asset management services, and, of course, it also has to select an auditor. But it undertakes both its administration and investment activities itself. Only a few funds operate such a simple structure. The main reason for this is that a fund's managers are elected from the members, and have to make decisions on the merits of very technical issues for which they usually need expert professional advice.

The simple structure referred to above also has another significant problem, namely that of ensuring that the costs related to asset management are properly accounted for. If the fund assigns an external organisation to pursue its investment activities, then all the costs charged by that organisation – and also the cost of investment expertise relating to asset management – can be clearly and separately accounted for. In contrast, in the case of asset management undertaken by a fund itself, the amount paid to the investment experts of the fund is an operational cost, which can only be accounted for as a charge on operational reserves.[14] But this can only be ensured if the fund works

14. The fund creates three types of reserves from the members' contributions in a prefixed ratio: the majority of contributions are included in the so-called insurance reserve that is credited on accounts held separately by members. The fund is also obliged to accumulate so-called liquidity backups, which serve as the backup of the fund's operational and investment risks. And finally, operational

with an operational cost ratio that is higher than the market average.[15] However, this can cause a perceivable market disadvantage, since practice shows that members are much more sensitive to this issue than to differences in investment yields that determine a fund's profitability more significantly.

Presumably the organisation-dependent character[16] of cost accounting also contributes to the fact that pension funds nevertheless do not usually engage in asset management, but conclude an asset management contract with a specialist institution. So, although it has an expert service provider for asset management, it is forced to employ an investment adviser with a high level of professional expertise. It should be pointed out that the deposit manager is institutionally obliged to check the asset manager from a professional point of view, and the auditor is also bound to approve the asset management provided. This regulatory requirement is unnecessary over-insurance, which − again − disadvantages self-organised funds that were established to represent in a genuine manner the interests of members, but that do not have expert managers.

The most widespread operating structure is when, in addition to the asset management activity, the fund also engages an external service provider organisation to undertake the fund's administration and those of its other activities requiring professional and technical expertise. In this situation, the fund's elected managers do not necessarily have to be technical experts and their main task can be the efficient representation of members' interests. For small funds this is the only workable organisational solution.

In practice, this organisational form has also been adopted in cases where the financial institution operating as the background institution of the fund wants to ensure that it retains the most profitable fund activity, namely asset management. The easiest way to guarantee this is if the members of the fund's executive bodies – preferably all of them or at least the majority – are effectively representatives of the interests of the background institution. For example, they are employees or executive officers of the background institution, while the "external" service provider firms are enterprises related to (*e.g.* being in the ownership of) the background institution. In many cases, the board of directors of a fund – consisting of the executive officers of the background institution – is in the position of deciding whether a fund's asset management should be contracted out to or kept by an asset management firm which is the background institution's own property, while accounting is done by a fund service provider that is also related to the business interest of the background institution. The law has only one requirement to resolve these conflicts of interest, namely that the custodian manager and the asset manager cannot be in the same ownership.

Of course, there are those among the market participants who know how to get around this rule. This can be done if the owner of one of the companies mentioned above is the parent company and is registered abroad, while the owner of the other is the background institution itself in Hungary. Then there is, legally, no conflict of interest. Alternatively, a board of directors consisting of the employees

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reserves have to be created from members' contributions to cover the fund's operating costs. On the pension fund market this ratio is usually: 95%-1%-4%.

15. Funds with a financial institution background have decreased the rate of operational costs deducted from contributions to a level that is significantly lower than that necessary. In their case it is not necessary to have a self-sustaining level of revenues for the operating costs, if they consider the profit of the asset management activity a part of the performance of the business's bottom line.

16. Among the funds data made public, it is not yet seen how the total operational costs (the amount actually utilised for operational and asset management purposes) relate to contributions or to the fund's assets, although where there is free market competition, this information could be the real measure of value.

of the firm which is the deposit manager and a background institution engaged in banking services can decide between them that asset management is to be done by the fund itself, but the expert to be employed as the investment director is actually one of the employees of the background institution's investment arm. In such a case, the real task of such an investment director is to channel the largest possible part of the investments made by the pension fund in such a way as to benefit the interests of the background institution. And though this sounds unethical, it is not actually that far from what really occurs and, in practice, the decisions made do not necessarily appear always to be contrary to the interests of the fund concerned.

The main question in all these situations is: how are the interests of members effectively represented where these are opposed to the interests of the background institution involved with a fund?

Role of the employer

In the former state pension system, the employer's role was limited to paying the contribution prescribed by law to social security in proportion to the wages paid by him. But during the pension reform, the employer's obligations and opportunities have changed radically in relation to the provision of an employee's pension.

While the obligation to make payments to social security remains, a separate law requires employers to comply with any employee's decision to make contributions to mandatory private pension funds from the pension contribution deducted from the employee's wages, by paying these and declaring that they have done so. Payments are made towards as many different mandatory private pension funds – according to strictly regulated formal requirements – as is decided by the employees of a firm. The administrative load on employers has increased significantly as a result. So employers' efforts to try to "encourage" their employees to be members of the fund (in better cases, funds) preferred by them, is understandable. Experience shows that this encouragement can take drastic forms in situations where an employer practically forces all of their employees to enter the same fund. Employers respect, more or less, the right of free fund selection in the case of joining voluntary funds, but in the case of mandatory private pension funds – due to the strict declaration system that requires considerable work – it is not surprising that employers try to ensure that all their employees join the same fund. Of course, this can work in the employee's favour, if the employer also undertakes continuous monitoring of the fund's activities. There are examples of an employer having the fund it selected (into which it enters all of its employees) analysed by an external expert. If that expert does not find that fund's performance satisfactory, then the employer undertakes to enter all of its employees – again, all into the same fund – into a fund which the expert considers more efficient. Only in cases where the employees are clearly disadvantaged by their employer's choice of fund, can any coercion to join the fund be challenged.

The employer's responsibility is further increased by the fact that the amount of pension that an employee can expect from the mandatory system, will be influenced more directly in the future by the size of the wages which the employer declares are being paid, and by whether the employer has regularly paid to the fund the contribution deducted from an employee's wages. On the one hand, this means that it is in the interest of workers to seek to minimise the "black" or "grey" wage, which is still significant in the labour market, though it is possible that it will take time for employees to realise this. On the other hand, it is not obvious that employees will be able to compel their employers to act in their (the employees') interests. Nevertheless, the fact that employees are notified in their annual individual account notices as to whether their employer has paid the contribution deducted from their wage to the pension fund, has had a perceptible influence in improving contribution payment discipline. Though the collation of declarations and payments puts a very heavy administrative burden

on mandatory private pension funds, it has produced noticeable results in the area of contribution payments. It must be noted, however, that the obligation on funds to report to the Tax Financial Supervising Authority any failure to collect contribution debts from employers has aroused their animosity. The enforcement of this regulation has faced serious opposition because funds are primarily interested in keeping members and they know that if they report an employer to the TFSA for failing to pay contributions, that employer will probably force its employees to leave the fund.

The most important change in the employer's role in relation to pensions is probably that the employer – as part of fringe benefits made to employees – can voluntarily contribute to the savings that an employee makes towards a supplementary pension. The employer can, as one option, undertake to pay a contribution supplement in addition to the mandatory membership contribution for employees who are mandatory private pension fund members. Experience shows that employers don't really like to do this, primarily because those who are not – and cannot be – members of the mandatory private pension fund cannot receive this benefit. And employers do not usually like those forms of benefit from which certain groups of their employees are excluded. At the same time, due to the contribution ceiling, this contribution can only be a limited amount,[17] which does not provide a really attractive form of benefit for employee groups receiving a higher income. In contrast, in the lower wage categories, it can mean too large a benefit is provided which may not be the employer's intention.[18] Small enterprises pay the employer's supplementary contribution supplement to the mandatory private pension funds, as the important objective for them is to minimise additional charges.[19]

Those employers, for whom the payment of the employer's supplementary pension contribution represents a part of the benefits they give their employees would prefer to pay this to a voluntary fund. In the initial period of the voluntary fund system, it could be observed that those employers who paid the supplementary contributions willingly undertook to establish their own, closed employer's voluntary pension fund. The employer's funds operating under the name of the company concerned significantly contributed to increasing the value of the corporate image of that company. Apart from its financial contribution, an employer usually undertook its own professional monitoring of the firms providing services for the fund and also a continuous analysis of the market situation. In addition, by exploiting its professional prestige, it often achieved very favourable service fees from the service providers. As a result, employees felt their savings were safe. It is noticeable that members made larger payments themselves to these closed funds than the average of payments for supplementary pensions which, again, shows the trust put in such funds.

But today, most of these employer's funds are terminated or merged into other funds. A further contributing factor is that certain employers, pleased with the success of voluntary funds started to organise mandatory private pension funds too. However, they were not prepared for the complexities involved and eventually had to give up providing their own pension funds. In many cases, the difficulties mentioned earlier, which are generally typical of the operation of small funds, had contributed to the termination of the fund. The cost of operating a closed fund exceeded its human

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17. In 2000, the income ceiling serving as the basis for contributions is HUF 2020 000. So the maximum amount of the contribution supplement that can be paid to private pension funds is 4% of that figure that is, a maximum of HUF 80 000 annually.

18. The employer is required to pay the same amount of contribution supplement for all [their] employees.

19. The contribution supplement paid to private pension funds means a net cost for the employer, which is not subject to further charges. That is, in the case of a small enterprise, it is very favourable for the owners declared as employees, if they pay the pension fund contributions credited on their own individual accounts for the charge of their enterprise as a cost.

resource advantages. The behaviour of the large pension funds, using not only marketing tools but also sometimes more importunate methods of member recruitment also contributed to this development though of itself such conduct it would not have been enough to get so many employers to give up their pension operations.

The main problem for the Hungarian pension fund market is not the current level of concentration of funds, but the small market share represented by employer's funds. This is the most negative characteristic of the development of the Hungarian pension fund market, as the vision of what the appropriate role for employers was to be, was much greater when the reforms were being developed than it has turned out to be in practice.

Instead of a summary

The Hungarian pension funds have been in existence for a very short time historically, as the time which has passed since their formation is a short one in which to collect savings, and even more so as far as providing pension services goes. However, the basic structure of the market has been put in place, and though there will surely be attempts to alter this, no fundamental change can be expected in its structure.

This brief study does not intend to undertake a detailed description of the state of the pension fund market, nor of the operations of the pension funds. Its aim is to identify those significant phenomena that have led to the emergence of the main features of the Hungarian pension fund market in 2000.

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Chapter 17

THE ROLE OF PRIVATE PENSIONS IN THE CZECH PENSION REFORM

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Developments before 1990

Social insurance on the territory of the Czech Republic has a tradition that is more than a hundred years old. To a certain extent, this history also influences the decisions being made on the future of the pension system.

The system of obligatory social insurance in the Austrian part of Austria-Hungary, which also included the Czech Lands, was introduced in 1888-1889 (the "Taaffe Reform"), along the model of Bismarck's reform in Germany. It had become clear, at that time, that the principle of voluntary insurance had not been very effective, since some employees did not take sufficient responsibility to provide for their own future. This experience, as well as the development of industry, and the changes in society as a whole, was the reason for the transition from self-help associations, trusts and workers' insurance funds, based on the principle of voluntary mutuality, to the system of obligatory insurance of employees. The Czechoslovak Republic adopted the original Austria-Hungarian social security regulations, which it then started to develop. The laws of the First Republic continued to have effect after World War II. The situation was greatly complicated by the fact that social insurance funds had either been confiscated, or devalued, by the wartime economy. An important milestone in the development of social legislation in the former Czechoslovakia, was the adoption of the Social Insurance Act in 1948. This law was modern and progressive in its time; it was based on the model found in the Beveridge Report. The law provided for the implementation of a new, unified, national insurance system, which placed on a more equal footing, the rights of blue-collar workers, and of other employees, and for the first time, extended old-age pensions to private farmers. After 1948, the original intentions of the Social Insurance Act became increasingly distorted; the new regulations, made subsequently, bore marks of the strong influence of the Soviet model. In essence, this meant that responsibility for the care of citizens was taken on by the state, as an expression of the ideology of the redistributive concept of socialism, that is, the transfer from a system of social insurance, to a system of social security. In spite of these tendencies, the Czech pension system did preserve certain elements of "insurance", because the right to a pension continued to depend on the length of the period of employment, and on the amount of income, although the relationship between these factors, and the amount of pension, was restricted, in various ways. This, then, was the background, that later led to the reform introduced in 1989.

Pension security in the Czech Republic before 1989 was, in principle, very generous, especially towards certain groups of individuals. This generosity was particularly reflected in the conditions for entitlement to benefits, rather than in the level of the benefits. In actual fact, all citizens were covered by pension security. Various forms of preferential treatment, using both benefit rates, and conditions of entitlement, gave certain groups better treatment than that available to those dealt with in the normal way, under the pension system. On the other hand, there were certain groups of people against whom the system discriminated – for example, self-employed persons. The usefulness of blanket provision of certain pension benefits started being questioned, when these benefits no longer met their purpose. The system of pension security provision was financed from the state budget, and contributions into the system were an undefined component of tax.

A critical analysis, of the relevant legislation that was in operation, was performed in 1990. It revealed serious defects in the system, that would have a very strong negative impact on the system of pension insurance, during the transition to a market economy. The main defects indicated were the following:

- The static nature of the system based on a system of restrictive provisions. No rules existed, to enable change in these restrictions to occur. The level of pensions could not, therefore, react flexibly to developments in wages and living costs.

- The amount of the pension did not adequately reflect the level of earnings obtained during the whole of a person's active working life. The pension was calculated only on the basis of the five best years (income-wise), out of the last ten working years before retirement.

- The lack of preparation for the future age structure of the population. In the future, the ratio of economically active persons to pensioners will decrease. This means that an increasingly smaller number of economically active persons will be creating the resources needed to pay for a growing number of pensions.

- Few options for individual decisions about the age of retirement.

- Insufficient protection for the system, against abuse of certain lax conditions.

- The impossibility of "transferring" accrued entitlements to other countries, at a time when freer movement between countries is possible (both during working life, and after pension age).

- The limited opportunities for obtaining individual, voluntary, forms of pension insurance.

Thus, in 1989, there was the legacy of an ineffective, complex, pension system, unable to respond to the expected demographic and planned economic developments.

The aim of the pension reform was to resolve these shortcomings. That has only been possible, however, by the implementation of essential changes, resulting on the one hand, in an improvement of the existing situation, and on the other hand, to certain unavoidable restrictions being put in place, to maintain feasible pension costs at a reasonable level.

Developments in the period 1990-2002

The pension system in the Czech Republic is not at the beginning of a reform "leap". On the contrary, it is in the midst of a reform process, which was started in 1990, as a consequence of the political, economic and social changes, that took place after 1989.

In 1990-1992, the discrimination against self-employed persons was removed, and preferential treatment abolished. The measures resulted in all economically active people acquiring entitlement to pensions, under uniform conditions, thus giving rise to extremely favourable conditions for undertaking future reform.

In 1993, pension insurance contributions were introduced, as a special payment outside of the taxation system. Draft legislation on occupational supplementary pensions was submitted to the government, for discussion. The government, however, rejected the concept, and an individual supplementary scheme, in an open pension fund, was created. In 1994, Supplementary Pension Insurance was brought into being, under the State Contribution Act.

In 1995, following major expert and political debates, a new Pension Insurance Act was enacted. It introduced the dynamism that the new economic conditions demanded. The process of increasing the retirement age was started, a flexible retirement age was introduced, the period for which earnings could be used, as the basis upon which a pension was calculated, was prolonged gradually, the definition of disability was specified more accurately, widower's pensions were introduced (contributing to the enforcement of the principle of equal treatment of men and women), and the compliance of the system with European Union rules, was ensured.

Since 1996, a special pension insurance account has been a part of the government's financial assets, allowing a clear definition, albeit within the context of the state budget, of the finances of the pension insurance system. In 1997, as a part of the austerity measures, indexation of pensions was tightened, and some non-contributory periods of insurance (*i.e.* periods when contributions are not paid, but which are taken into account in the calculation of the benefit amount), were made stricter. However, the scope of non-contributory periods still remains very generous, compared to other countries. In 1999, an amendment to the Supplementary Pension Insurance, with the State Contribution Act, was enacted, enhancing, somewhat, the security of deposits made by scheme members, but mainly expanding the possibilities for increasing the state contribution, providing tax advantages for employers paying contributions on behalf of their employees, and providing a tax allowance for a part of the contribution paid by scheme members.

In 2000, a high-level Interim Committee for Pension Reform was established. in the Chamber of Deputies. In November 2000, the government submitted to the parliament the Social Insurance Agency Bill. The aim of this legislation was to separate the financing of social insurance, from the state budget, and thus to enhance the transparency of the management of social insurance resources, to reduce the dependence of this management on political decisions, and to allow better and more flexible contact with clients. However, its main purpose was to create, by transforming the current scheme into a modern entity, the prerequisites for further reform steps.

In 2001, an amendment to the Pension Insurance Act provided for an actuarially fair reduction of old-age pensions, where a member of the scheme retired early, and for an increase, where retirement was deferred. In April, the government approved, and sent to the parliament, for further discussion, its report on the "Further Continuation of the Pension Reform". In October, the parliament rejected the governmental draft amendment of the Supplementary Pension Insurance with State Contribution Law, and also, after discussions which lasted one year, the draft on the Social Insurance Agency. The

financing of social insurance has, thus, remained part of the state budget. In October, the government sent to the parliament the new law on Occupational Supplementary Pension Insurance, but in December, it was also rejected. The Parliamentary Committee on Pension Reform finished its deliberations in December, without reaching a consensus on the next steps to be taken. In the period 1990-2001, pensions were adjusted, sixteen times. After the experience of (not very successful) government legislative initiatives during the last two years, it is much more apparent, that broad political and expert consensus is the most important condition, for further development of the scheme.

In order to promote broader consensus among different countries, the Czech government, in 2002, together with the government of the Netherlands, prepared the Joint Memorandum on Pension Reform, for the Summit of the EC in Barcelona. Its aim was to support the principles of the welfare state, and the post-Lisbon discussions, and to indicate that the Czech government was ready to be included in the discussions, between EU Member States, on the future development of the Member's pension schemes.

The current situation in pension reform development

There are a number of problems that need to be solved, both in the mandatory, basic pay-as-you-go (PAYG) pension insurance system, as well as in the voluntary, private, fully funded supplementary scheme:

- The decrease in the real value of pensions.
- The high degree of levelling out of pensions, resulting, in particular, from the unsuitable method of calculating pensions (the degree of levelling out still remains higher than prior to 1990).
- The increase in the number of early retirements, resulting in stagnation of the real retirement age (men 60 years, women 56 years).
- The increased proportion of pensioners, compared to the total number of those paying contributions, resulting, in particular, from demographic developments, the increased number of early retirements, and the reduced the rate of economic activity.
- The low contributions paid by the self-employed: this has led to the cost of paying their benefits being increasingly transferred to employees, employers, and the state budget.
- The number of people not contributing to the system (approximately 30%), which has become the main reason for the imbalance between income from insurance premiums and expenditure on benefits (the so called non-contributory periods).
- Insufficient security for assets invested in private supplementary schemes.
- Insufficient transparency of management, and the high costs of administration.
- The short-term nature of the supplementary scheme, which serves rather as an advantageous savings scheme, and not as the means of providing funds for old age. The support provided by the state (contributions and tax deductions) does not therefore fully fulfil its aim.

In April 2001, the government approved the report prepared by the Ministry of Labour and Social Affairs, The Concept of Continuation of Pension Reform. The report addressed the present, and future, problems of the pension system, and contained proposals for possible developments, and necessary changes.

The report was sent to the parliament, for further discussions. After several months of discussions, it has become clear that the government concept is the only detailed concept in the country. Nevertheless, there are also other quite different ideas, presented by certain political parties. For example, the ODS party prefers a low flat-rate pension, with voluntary savings on top of it, whereas the Union of Freedom prefers mandatory private savings, as a second pillar. Thus, it is clear that the concept proposed by the majority in the parliament for further development of the Czech pension scheme, may only be adopted after the election, which takes place in June 2002.

The following principles of the future pension system are part of the government report, from April 2001. In spite of different opinions on future developments, it seems that they may be taken as the guidelines for any future reform:

– *Maximum possible participation (coverage) in, and uniformity of, the system.* The basic mandatory system must not motivate the economically active population to evade the legal labour market, so as to avoid payments of premiums. The system must not contain preferential treatment, for any group of insured members. Additional voluntary pension systems must provide maximum incentives for participation (security for investments made, tax advantages, and a variety of products offered).

– *Financial feasibility of the system*. Taking into account short-term and long-term projections, the basic mandatory system must be continuously adapted, to ensure its long-term durability, in the light of the ageing of the population, and to ensure its ability to react to demographic developments, migration and inflation. The essential parameters of the system must be adjusted, so that benefits will be at an appropriate level but, at the same time, the costs of the system must not excessively burden the economically active part of the population.

– *Maintenance of solidarity between generations, in the process of payment* for the basic PAYG system. Additional forms of capital saving, in typical financial products, should be supported, in their voluntary forms only. Among the other factors, to be taken into account, it should be remembered, that such systems require considerable costs for the transition period, and involve a high level of social risks, related to the introduction of mandatory systems of saving.

– *A stronger link between the amounts of premiums paid, and the amounts of benefits received* would limit excessive levelling out within the basic system; additional systems should be developed on the basis of the principle of full equivalence.

– *A guaranteed minimum income,* for a pensioner, should ensure that, after many years of participation in the system, a pensioner should not be dependent on income *(i.e.* means) tested social benefits.

– *Increased personal responsibility* by citizens, and also by the state (or system administrators). This responsibility must cover preparation for old age, the security of the system, and the availability of information to the population.

– *Improved trust of the population in the insurance system,* by means of the increased transparency of the system, and its transformation, from a state body, to a public Social Insurance Agency. Such an agency would be able to fulfil the tasks related to future changes, in the area of incomes and benefits, and will become a client-orientated institution, providing financial services, and information, with the support of the latest technology, so that members can be aware of how their contributions are used.

– *An improved rate of employment,* by eliminating any motivation for early retirement, by eliminating barriers for entering the labour market, and especially by supporting the longest possible period of economic activity of each person.

– *Fulfilment of the requirements resulting from relations with the EU* – not only by means of harmonisation of legal regulations, but also through the quality of their implementation, and enforcement.

The concept of the government

The pension system will be based, in the future, on a mandatory PAYG system, guaranteed by the state, and on voluntary private, supplementary, fully funded schemes. The proportion of the income of those on old-age pensions, to which such voluntary private schemes will contribute, will be gradually increased, up to approximately one-fourth of the total. The system will ensure appropriate compensation for low-income, medium-income and upper medium-income groups.

An average old-age pension, on the level of 55-60% of gross salary (about 45% of net salary), will be provided, from the basic mandatory pension insurance system, for at least another 10 years. Currently, the amount of pension received decreases, as a proportion of total salary, as an individual's salary increases. The proportion of total salary, which can be received as pension benefit will, in future, be increased, thus strengthening the principle of equivalence.

After 2010, following the development of other additional systems, the above-mentioned incomes of pensioners, from the basic system, will be supplemented, with additional incomes from voluntary private, supplementary, pension schemes, with the state contribution to these amounting to another 7-10% of net pre-pension income. There will be additional incomes, from supplementary occupational pension schemes, amounting to another 7-10% of net pre-pension income.

The system of basic, mandatory, pension insurance will be guaranteed by legal, economic and administrative methods.

Fundamental principal corrections will be made in the PAYG system, which will ensure the stability of the system. As an alternative, it is proposed to arrange a gradual transition, from the current defined benefit (DB) PAYG system, to the notional defined contribution (NDC) PAYG system. The introduction of this latter system would make possible the carrying out of a fundamental reform of the pension system, in a gradual way, and without large additional costs. Moreover, a smooth transition to an NDC system could be arranged, without creating significant differences between the pensions granted during different periods (prior to starting, during, and after the end of the transition). The transition to the NDC system will make considerable demands on the administration of the insurance system, since the new system is typified by a high demand for information. This is related, among other things, to the fact that individual accounts for insured persons will have to be established, and managed, and that, for a certain period, two different pension systems will have to exist alongside each other.

The current state administrator of the insurance system (the Czech Social Security Administration), will be transformed into the public Social Insurance Agency, the finances of which will be separated from the state budget. This agency will be responsible for improving the system's administration, and its transition to an up-to-date client-orientated financial institution. This is the only way in which to create the pre-conditions for further reform measures. Experience from abroad has shown that underestimating the need for a thorough preparation of the administration of the system, may jeopardise any reform, however well-intentioned. Therefore, the establishment of the Social Insurance Agency, is considered to be a high priority.

Additional pension schemes will be further developed, by means of the establishment of the second pillar of the system (collective employee's insurance), in compliance with best practice in developed countries, and by strengthening the security, and transparency, of the third pillar (individual systems of private, supplementary, pension schemes, and life insurance), and increasing its long-term nature.

Overview of the supplementary pension scheme with state contribution

The supplementary pension scheme was designed, in order to allow people in the pre-retirement age group, to enter into the system. Between September 1994, when the first private pension funds received their licence, and the end of 1996, more than 1.5 million people entered the supplementary, private, pension scheme (in 2002, the number of participants exceeds 2.5 million). On the other hand, the supplementary, private, pension scheme became characterised, as a short-term saving scheme for purposes, other than those of providing a supplementary income in old age, which was undesirable. This was partially due to the low retirement age, for receipt of the old age pension (50 years), and to a short vesting period for a pension (maximum of five years).

After its successful start, in 1994, the system began to show signs of stagnation. In spite of the fact that wages were growing, participants were not increasing their contributions, and the average contribution level remained at approximately CZK 300, and. the participant's maximum contribution limit of CZK 500 has not been increased. The state contribution has not been adjusted, so that it can increase when the participant's contribution increases. The state supervision of this system is restricted in its extent.

After several years of the system's operation, the long-term aspects of the supplementary, private, pension scheme were strengthened, and a greater emphasis was placed on its purpose as a support in old age. The amendment of the Law on Supplementary Private Pensions introduced stricter conditions (for instance a retirement age of 60 years). At the same time, it introduced further incentives for participation in the system – a higher state contribution, tax allowances for participants, and also for employers, if they make contributions to the funds of their employees' pension schemes.

The supplementary private pension scheme, with state contribution, is based upon long-term payments of smaller contributions to a pension fund. The pension fund increases this capital, by making appropriate investments. Participants themselves decide on the amount of their contributions. The state provides, to each participant, a state contribution (CZK 50-150, monthly).

The fundamental benefit of the supplementary, private, pension system, is the old-age pension. Apart from this, the disability pension, and the short-term survivor's pension, can be provided. Only DC types of plans are allowed.

The amendment of the Law on Supplementary Private Pensions, in 1999, terminated the provision of temporary old-age, disability, and retirement pensions. Once a participant in the scheme

has met the conditions for entitlement to a pension, that participant can decide to have, instead of the pension, all the money to which they are entitled, in the form of a one-off settlement. If a participant wishes to leave the supplementary private pension scheme, before becoming entitled to a pension, the participant receives back the contributions paid, in the form of a severance payment. This includes the investment returns, but not the state contribution, or the returns from the state contribution. As the supplementary pension scheme will not have met its purpose, the state contribution does not belong to the participant.

Enrolment in the supplementary, private, pension scheme, with a state contribution, is voluntary, for the participants. The enrolment conditions are: a minimum age of 18 years, and permanent residence in the Czech Republic. There are no links to working in a particular occupation, or at all, as this is not a system based on employment, but on the concept of participating in civil society. Remaining in the scheme is a voluntary decision of the participant, who can leave it at anytime. If the participant does leave the scheme, the financial assets deposited will be paid back to the participant, in the form of a severance payment, as described above.

The amount of the life pension is determined, on the retirement of the participant, by dividing the money held in the participant's individual account, by the period of the participant's average life expectancy, as set out in the mortality tables of the Czech Statistical Office. The amount of a pension is not pre-determined, in the defined contribution scheme. It depends, not only on the amount of the participant's contributions, and the state contribution, but also on the level of returns obtained by the pension fund's investments. It also depends on the retirement age, and on the participant's gender (mortality tables vary for men and women).

Where a participant is dissatisfied with their pension fund, they can, at any time, give two months' notice to leave, and enter another pension fund, and also obtain the transfer of their financial assets. It should be noted that changing pension funds is not economically beneficial for participants, because of the administrative costs involved. However, if a participant is not satisfied with their current pension fund, it is preferable that such a participant changes their pension fund, but remains in the supplementary private pension system, rather than leaving the system altogether.

A private legal entity, private joint stock companies, that is, pension funds operate the supplementary private pension schemes, with a state contribution. Pension funds have stricter rules for the establishment, operation and termination of their activity, than ordinary joint stock companies. The principal ones are that:

- Approval of a state authority is necessary, for the establishment, and termination, of their activities, and for a consolidation, or merger.

- The registered capital of a pension fund must amount to at least CZK 50 million (CZK 1 million is sufficient for an ordinary joint stock company). When the fund starts up, this must be constituted, only, by a monetary deposit, and paid up, prior to submitting an application for the pension fund's establishment.

- The law defines rules of safe, and provident investments, for the purposes of the private pension funds, and preference is given to a safe investment, with lower returns, rather than a risky investment, with higher returns.

- Certain mechanisms exist, to control the funds (rules about deposits, state supervision of the pension funds).

- The method of profit distribution is defined by the law – a maximum of 10% of the profit belongs to the shareholders, a minimum of 5% of the profit belongs to the statutory fund, and the remaining amount is distributed, for the benefit of the participants.

- Members of the management board, members of the supervisory board, and the secretary of the pension fund, are subject to approval by the state authorities, and must comply with requirements for professional competence, have no criminal record and must be in compliance with the rules against potential conflicts of interest, in terms of their other work activities.

- The state supports the supplementary private pension system, in four ways.

State supervision of the pension funds

The activities of pension funds, and of their depositories, (the banks that maintain pension funds accounts) are subject to state supervision, by the Ministry of Finance and by the Securities Commission. Such state supervision comprises both controls and sanctions (for instance, the imposition of penalties, the suspension of the entitlement of the management board to handle the pension fund's assets, and the ability to appoint custodian, and to withdraw of a licence to operate a pension fund). The purpose of state supervision, is to protect the participants' interests, both the security of their accumulated financial assets and, in individual cases, for instance, to ensure compliance with the supplementary pension scheme agreement.

State contribution

The government makes a contribution to the pension fund, to add to the participant's contribution, from the state budget. The minimum monthly amount of the state contribution is CZK 50, where the participant pays a contribution of CZK 100. The maximum co-contribution is CZK 150, where the participant pays CZK 500, or more. A participant can obtain a maximum of CZK 1 800 annually, as a state contribution (compared with certain other types of savings, where the maximum state contribution represents CZK 4 500, yearly).

At the beginning of the system, in 1994, state contributions were lower, but they were increased by 25%, during its first two years. Legal changes, adopted in 1999, which amended the Law on Supplementary Private Pensions, and which came into effect on the 1 January 2000, laid down that contributions would remain, permanently, 25% higher. The state contributions have not since been adjusted.

Tax allowances

Tax allowances are available to pension funds, to offset against the returns from their financial activities, so, in fact, most pension funds pay insignificant amounts of, or no, income tax.

Tax allowances were introduced, with effect from the 1 January 2000, for fund participants, and for employers, who pay contributions for participants:

a) Each participant, who has paid more than CZK 6 000 in contributions in a year, can deduct the amount above CZK 6 000 from their income tax base. For example, a participant who has paid a monthly contribution of CZK 1 700, will be provided with a state contribution of CZK 500, and can deduct CZK 1000 from the tax base, but for the remaining 200 CZK there are no further benefits provided by the state.

b) Contributions can be paid on behalf of, and with the agreement of, the participant − employee by the employer. The contribution paid by the employer to a pension fund, has the following tax allowances:

   – The contribution can be included in the employer's costs, up to the amount of 3% of the assessment base of the participant-employee, for social insurance, and for the state employment policy contribution.

   – The employee is not taxed on income, arising from the contribution paid by the employer, up to a sum equal to 5% of the employee's assessment base, for social insurance, and for the state employment policy contribution.

   – The tax allowance related to the participant – employee's income, motivates the employer to pay a contribution which, in size, corresponds with the amount of the wage. In view of the fact that the supplementary retirement income should be a substitute for the previous income received from employment, the link between the amount of contribution, and the amount of income, is logical.

Allowances for the payment of insurance for the mandatory insurance

The contribution for the supplementary private pension scheme, with the state contribution, paid to an employee's pension fund account, by an employer, is not included in the assessment base, for the above-mentioned types of mandatory insurance.

Currently, there are a total of 14 private pension funds in operation, of the original 44 private pension funds. The number of pension funds decreased, as a consequence of their consolidation into larger entities, with 11 funds being liquidated. The number of participants in the dissolved funds, who have had their benefits affected, represents 1% of the total of 2.5 million participants. Further liquidations are not envisaged, though further consolidation of pension funds is expected. The average age of participants has remained at 48 to 49 years.

Foreign shareholders have gained a strong majority position, in many pension funds. The volume of assets, in the pension funds, exceeds CZK 55 billion. To date, the participants have received CZK 14 billion in state contributions; in 2001 alone, these were close to CZK 3 billion.

The composition of pension funds portfolios includes bonds (57%), treasury bills (23%) and stocks (8 %). The average investment results achieved range closely around the inflation rate, maintaining the real value of the money deposited.

The main concerns for the current supplementary, private, pension scheme, with a state contribution, include:

– Insufficient security of the funds deposited, caused mainly by the fact that the activities, and intervention of state authorities, are diffused, and slow.

– Insufficient transparency of management, as a result of the nature of the separation, of the financial assets of the participants, from those of shareholders.

– High operation costs, mostly as a consequence of the individualised (open), nature of the system.

- The short-term character (so far) of the supplementary private pension schemes, that serve, rather, as a convenient means of savings, and not as a method of old-age security.

One of the aims of the amendment to the Law on the Supplementary Private Pension with a State Contribution, was to improve the current situation of such funds. This was to be done, mainly, by increasing the stability and safety of the system, as well as improving the effectiveness of state supervision. The alterations made can be characterised as necessary changes, to the current legal regulation, due to both EC requirements, and the practical experience gained from operating the state supervision requirements. The proposed changes were, mainly, aimed at:

- Increasing the transparency of the management of the pension funds, by the separation of the pension fund's assets from the assets constituted by the participants' contributions, the state contributions, and the returns coming from these contributions.

- Increasing the cost-effectiveness of the management of the participants' assets.

- Expanding the investment opportunities of the pension funds.

- Making state supervision stricter, and strengthening the role of public control.

- Harmonising the framework of legal regulations, with international law, international treaties, and EU legislation, in association with entry into the EU.

The draft was rejected in October 2001, by the Czech parliament, and a new draft can be prepared only after the election in June 2002.

Characteristics of the newly prepared supplementary occupational pension scheme

At the beginning of October 2001, the government submitted to the parliament, after more than two years' preparation, the draft of the Law on Occupational Pension Funds. In December, the parliament rejected the draft, so the next attempt at passing this law can only be tried after the election, *i.e.* not before the end of 2002.

In the Czech Republic, the necessary conditions for the development of closed-end occupational supplementary pension schemes, functioning on similar principles, have not yet been created. The existing system of the supplementary, private, pension schemes, with a state contribution, and several products offered by insurance companies, are using the tax advantages, which exist for contributions paid by employers, for the benefit of individually concluded agreements, with employees who are the clients of companies (pension funds, insurance companies). This system, however, does not make use of all the advantages of the European model of occupational pensions. The current system must ensure financial benefits, for the participants in the supplementary, private, pension scheme, whom companies must individually win into joining, and keep in a fund, at a high cost, in a competitive environment. It must also be economically viable for the pension funds' owners, who will have invested considerable financial resources into the pension funds' operation, and who expect profits corresponding to the returns on their financial investment. When compared to the West European and American occupational pension systems, which do not compete with each other, the following characteristics of the current pension funds emerge. The tendency of the market to be concentrated in several large pension funds, controlled by foreign financial groups, which results in similarities in the benefits received, and in terms of investment strategies. And at the same time, the system lacks transparency for individual contributors, as this is prevented by the competitive nature of the system, and by the requirement for the protection of the business interests of the pension funds shareholders.

The draft, submitted to the parliament, of the Law on the Occupational Pension Funds, was based upon the experience of the EU Member States, the US, and other developed countries. It regulated conditions for the establishment, and development, of the occupational pension funds system, operated by non-profit pension companies, and established by employers, through occupational pension funds, administered by them, but separated from them, in terms of accounting. It also regulated the operational, and investment activities, relating to the administration of occupational pension funds, and established the supervision of them by the state.

The objective of the introduction of the new supplementary pension system was not to create a substitute for the existing systems (private pension open funds system, with a state contribution, life insurance). The objective was, rather, to complement the range of pension fund schemes, with those of the occupational pension funds, which are a standard worldwide. The importance of private, supplementary, pension savings, as an income source for retired citizens in the ageing Czech population, will necessarily have to increase, as is demonstrated by the Concept of the Continuation of the Pension Reform, approved by the government on 2 April 2001. Therefore, it is vital to introduce all proved, effective and safe types of pension schemes. In countries with a developed market economy, the significance of private supplementary pension systems has been growing, and forms the most fundamental element of pension systems.

The reason for the wide use of occupational pension schemes is their connection to the employment relationship, and the comprehensive care that an employer should provide for his employees. This comprehensive care is the result of a social dialogue within a company, and its specific form is negotiated, within the collective bargaining system, on a company, or sector, level. The occupational pensions represent, in this regard, deferred wages, protected by the wage protection system, and guaranteed by the laws relating to the employment relationship. The guarantees of the system by employers, the ease of communication by the pension fund custodian, with the employer, and the non-profit nature of this pension system, create very favourable conditions for promoting its transparency, its cost-effectiveness, and safety, from the point of view of the employees. The proposed occupational pension system sought the maximum simplicity, safety, effectiveness, and transparency. It would have been, in many ways, different from the fundamental principles of the current, private, pension fund schemes, with a state contribution.

Occupational pension schemes were to be financed only from the contributions of the employees, and their employers, and from the returns obtained by the group investment of these contributions, through qualified external custodians.

Occupational pension funds were not to be subject to commercial trading (*e.g.* takeovers).

Competition costs relating to winning members into pension schemes, mainly through dealers, were not to exist in the occupational pension funds system.

The pension companies' priority was to be the interests, and needs, of the participants, in obtaining the maximum long-term returns for them, and not the short-term interest, in profit, of the owners of a joint stock company This aim was evidenced, by the fact that such occupational pension schemes do not allow for early withdrawals of the asset, which are intended to provide the old-age income.

Pension companies were to be permitted to administer more than one occupational pension fund each, which would allow for achieving cuts in operational costs, when compared to the concept of one custodian, one pension fund. (The idea was that an employer was to be able to offer employees a range

of pension schemes, which would differ, both in terms of the benefits offered, and in terms of the investment strategy.)

Only defined contribution pension schemes were to be allowed, and portability of the funds' assets was to be ensured. This meant that, on a change of employment, an employee could take their assets to a new employer's pension fund, thus ensuring that labour ability would not be impaired.

Employee representation would have a significant role, in the activity of the occupational pension funds system. Employees were to be the owners of their pension savings, that were to be entrusted into the custody of a pension company. They would participate in decision-making about the management of the savings, through their elected representatives, on the pension companies' bodies.

The establishment, and operation of, an occupational pension fund, was to be the subject of collective bargaining (mainly in relation to decisions about the amount of contributions, which in fact represents deferred wages).

The new system would have the minimum of administrative requirements, both in relation to the pension companies, or the external custodians managing them, and in relation to state supervision. Matters relating to the individual collection of contributions, and to the processing of claims for the state contributions, business activities, associated with winning members for the fund, and relationships to dealers, advertisement agencies, and the like, were to be eliminated. Due to its lower operational costs, the system should have enabled participants' assets to grow faster, leading to higher supplementary pensions. This is the long-term experience of countries, with the strongest private pension systems.

The operation of occupational pension funds was to be transparent, and to be consistently separated, in legal and accounting terms, from their founders, and their operational and investment custodians.

The nature of the individual accounts, in a fund, would have accurately, and continuously, given a true picture of the value of the fund's assets belonging to each individual participant (which would have depended on the amount of contributions paid by the participant and their employer). This would have contributed to the system's transparency.

Operational costs of the funds were to have been transparent, as fees for the funds' operational and investment administration, would have been defined by the law. They would have been paid from the assets in the occupational pension fund, and their amount was to be limited, as no fees, other than those defined by law, could be charged to an occupational pension fund.

The participants would have had easy access to information on the pension fund's activities, and on its benefits, through the pension company administering the pension fund, through their employer, or through the trade unions, of which they are members. Participants would also be able to request explanations, without delay, from their pension company representatives, whom they would meet daily, at their workplaces.

External investment administration, through state authorised investment custodians, which was to have been mandatory for the occupational pension funds, would have contributed to the security of the pension savings, to higher professionalism in their management, and to achieving higher returns for the participants. The founders of the pension companies, their internal committees, or the members of such bodies, would not themselves be able to invest the assets of the occupational pension system.

Occupational pension funds would have contributed to competition amongst investment custodians, who were to be forced to offer their services, at advantageous prices, and to prove their long-term investment achievements, in the administration of a conservative portfolio, in the sphere of supplementary pension systems.

The occupational pension funds were to have been able to use, if they wished, for the purposes of paying out benefits, the services of external entities, *i.e.* insurance companies and pension funds, providing pension schemes, with a state contribution, and, in this way, they would contribute to the development of the annuities market, in the Czech Republic.

The occupational pension funds would have contributed to social programmes of successful companies, where they would have strengthened the company's team spirit, and helped in the sphere of collective bargaining.

Among the fundamental changes they were to bring about, as compared to the private pension fund schemes, with a state contribution, and life insurance, was the use of a non-profit legal entity, for the purpose of occupational pension fund administration. This development was based upon international experience. The elimination of competition, during the process of enrolling participants, and distributing returns from the contributions invested, markedly decreases the costs, and increases the returns of a fund, and, at the same time, improves the participants' benefits. Another fundamental change, was to be the competition between the external investment custodians of the pension funds, from which participants would clearly have benefited.

The occupational pension system was to be operated by an independent legal entity, a pension company, separated, in terms of accounting, from the pension fund, that would represent the volume of the participants' pension savings (employees' and employers' contributions, and returns), and from its founders.

The non-profit nature of the administration, and distribution of the returns of the fund, would have guaranteed that investment returns would only be used for financing supplementary pensions. This would have meant, that the costs of creating a pension in an occupational pension scheme, would be lower than, for instance, those of creating one through a private pension fund, with a state contribution. The pension fund was to be administered by representatives of employers, employees, and pensioners, sitting on the internal committees of the pension company. They would decide on all major issues, mainly with regard to the fund's management, the selection of investment custodians, decisions about investment strategy, and the distribution of returns. The actual expert activities, most of all the investment of financial assets, were to have been carried out, for an agreed fee, by the external custodians, who would regularly have presented the results of their activity, to the pension company's committees. If their results were not satisfactory, they could be replaced. Occupational pension funds were to be separated from employers, who would not have the chance to make decisions affecting them, nor to misuse their financial assets. Investment, into the firms of the founders of the occupational funds, was to be largely restricted by law.

A competitive environment was to be applied, mainly in the sphere of operational, and investment administration, where, as mentioned before, it would have resulted in cutting down costs, and thus in higher returns, for participants. Competition would not have been permitted, in relation to enrolling participants, as competition markedly increases costs (dealer services, business units, advertisement, and the like), and represents a burden on the funds, not only for the current year, but, also, for the future.

A special tax regime, relating to employees' and employers' contributions, to returns from the financial management of the pension funds, and to the paid benefits, similar to that of the "private pension funds system, with a state contribution" was proposed, in order to support occupational pension funds. The state would control the activities of the occupational pension funds, through supervision. State supervision was to be founded, on the same principles as that of the "pension funds with a state contribution", in compliance with the Act No. 42/1994. State supervision was to be carried out by the Ministry of Finance, and the Securities Commission.

Based on experience from other countries, the proposed system provided conditions for operating occupational pension funds, with a minimum of administrative staff, and a minimum of costs, so that, if an employer ceased to exist, or an employee changed employment, this would not threaten the occupational pension fund, or the participants.

It was assumed, that only large employers, or groups of employers (in developed countries there are often sector pension funds) who were successful, and had the prerequisites for long-term economic development, would found independent, occupational pension funds.

Private insurance

Pension insurance is provided by private insurers as a part of life insurance (which also provides other forms of life insurance, endowment insurance, whole-of-life and endowment assurance, investment insurance). Provision for-old age may be taken out in the form of pension insurance or endowment insurance. The latter, however, is often taken out (under a different name), to ensure the security of children.

While supplementary, pension insurance, with the state contribution, managed by pension funds, is designated as a provision for members' old age, private insurance covers a whole range of insurance claims, of which old age is only one. Insurance policies, commonly, combine various insurance claims, and it is only possible to separate out the pension products designated for old age with limited accuracy. These products are currently covered by insurance contracts, concluded between a beneficiary of insurance, and an insurance company.

Insurance companies offer many variants of pension insurance. Such insurance usually contains a provision for a life annuity ,to be paid from an agreed date of termination of insurance, for a temporary pension, to be paid, in the event of full disability, or from the date of the termination of insurance, for a bereavement pension, for exemption, from payment of contributions, in the case of full disability, while maintaining all entitlements from insurance, a share in profits, even after the beginning of payment of a pension, the return of contributions, paid in case of death, before the end of the qualifying period.

Instead of regular payments of an annuity, the policyholder has the option of taking the amortised value of the pension, in one lump sum, including a share of profits, of deferring the start of payment, or of choosing a shorter period of payment (when a higher pension is paid). The employer has the option of concluding a collective pension insurance agreement, on behalf of his employees.

In 2001, tax allowances have been extended, to insurance products designated as the old-age provision of private insurers. The tax allowances do not apply to collective insurance − *i.e.* policies signed by the employer, as policyholder with the insurance company, for the benefit of employees.

The higher premium rates of private companies imply that their clients come mainly from middle and high-income groups. For such persons, private life insurance may be an effective way of providing a supplementary income, in old-age.

Table 17.1. Proposed target structure

Parameter	First pillar: Pension insurance	Second pillar: Occupational supplementary scheme	Third pillar	
			Open supplementary scheme	Private insurance
Guarantee by the state	yes	no	no	no
Extent	all economically active persons	groups of persons by occupation	individual	individual
Participation	obligatory	voluntary	voluntary	voluntary
Financing	PAYG	fully funded	fully funded	fully funded
Relation of contributions and benefits	alternative 1: DB alternative 2: NDC	DC	DC	DB
Amount of benefits	alternative 1: based on the period of insurance and achieved income alternative 2: based on the amount of contributions paid and individual lifetime (regardless of sex)	based on the amount of contributions paid	based on the amount of contributions paid	based on the amount of contributions paid
Solidarity	between generations and income groups	none	none	none
Tax deductions	yes	yes	yes	yes
Contribution by the state	Tax deductions	no	yes	no
Administration of the system	Government	private	private	private

Source: Author for the OECD.

Supplementary Pension Insurance in the Czech Republic
(Statistical Data)
1994-2001

Figure 17.1. Number of pension funds

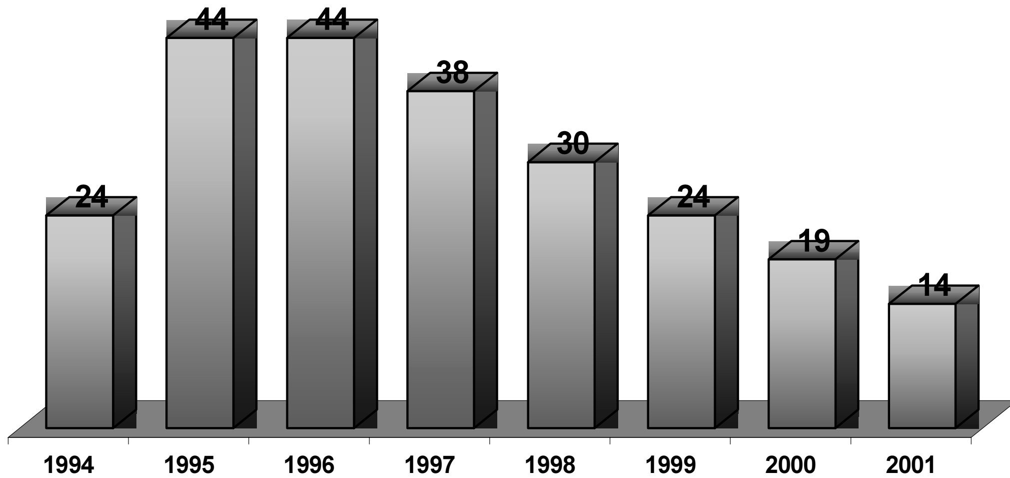


Figure 17.2. Public funds assets

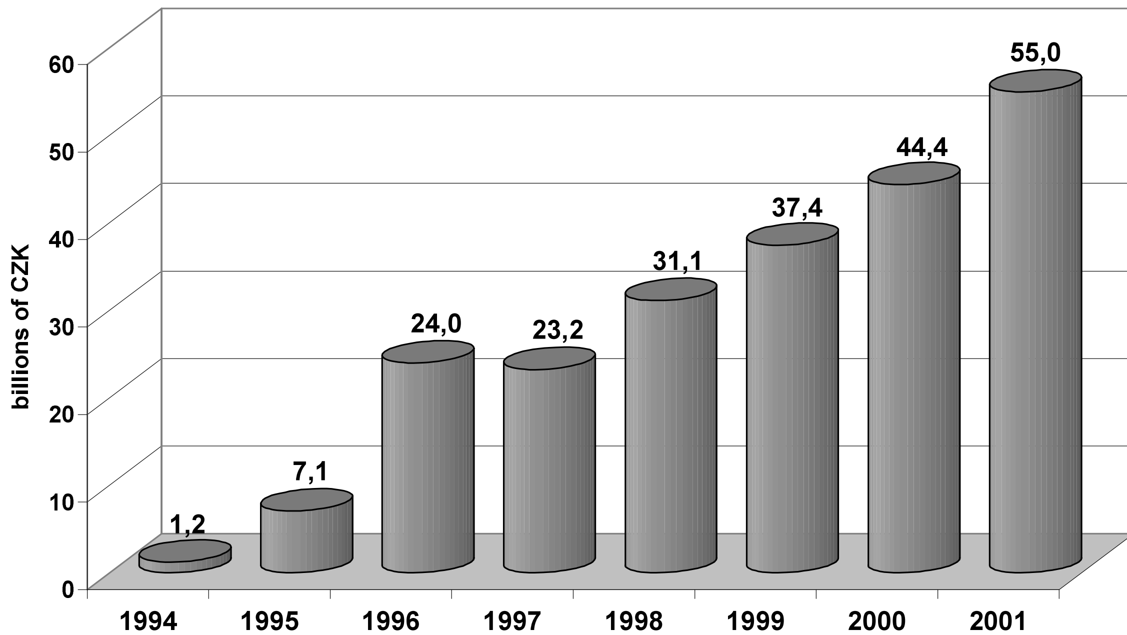


Figure 17.3. Number of participants

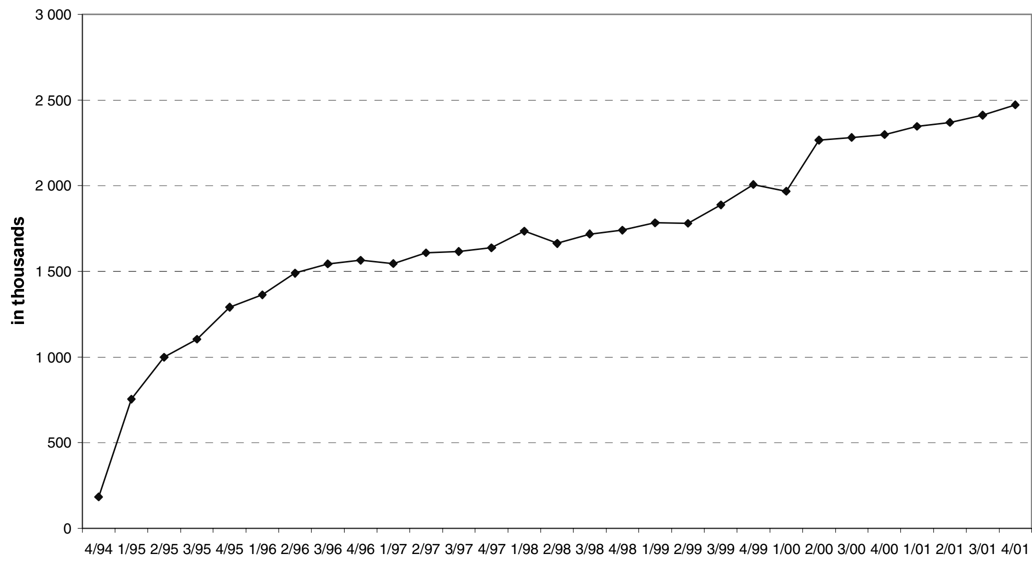


Figure 17.4. Income and expenditure of pension funds

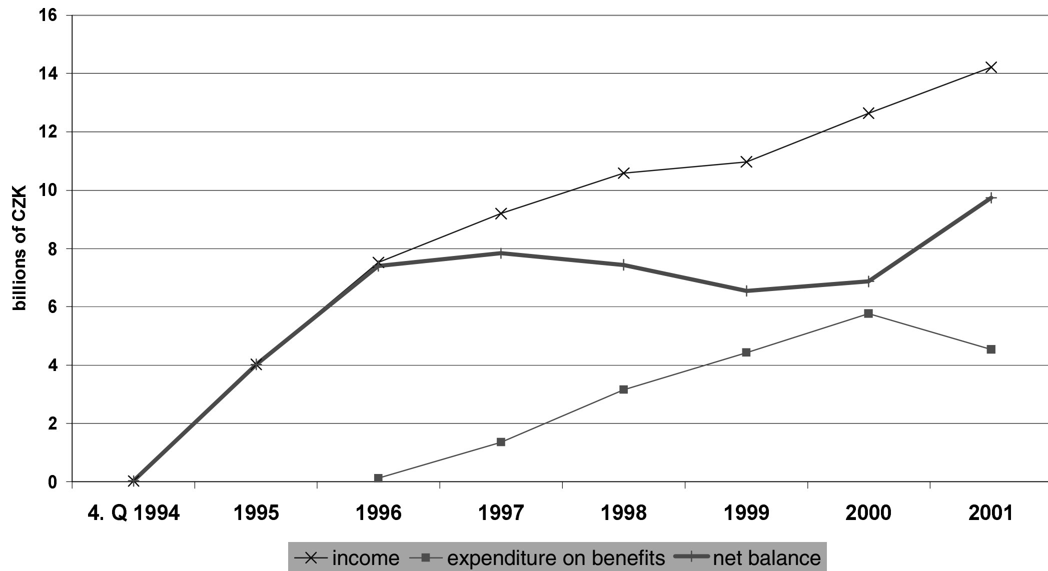


Figure 17.5. Development of average monthly contribution

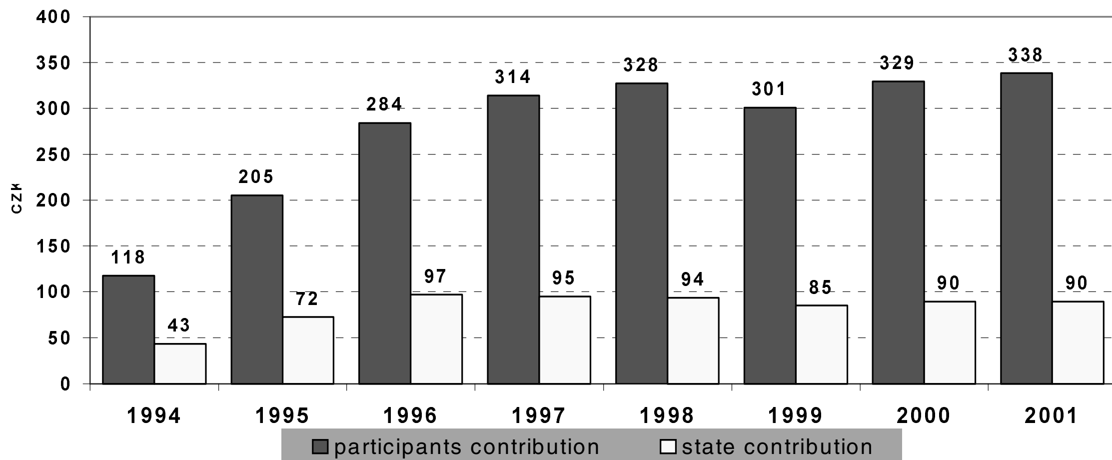
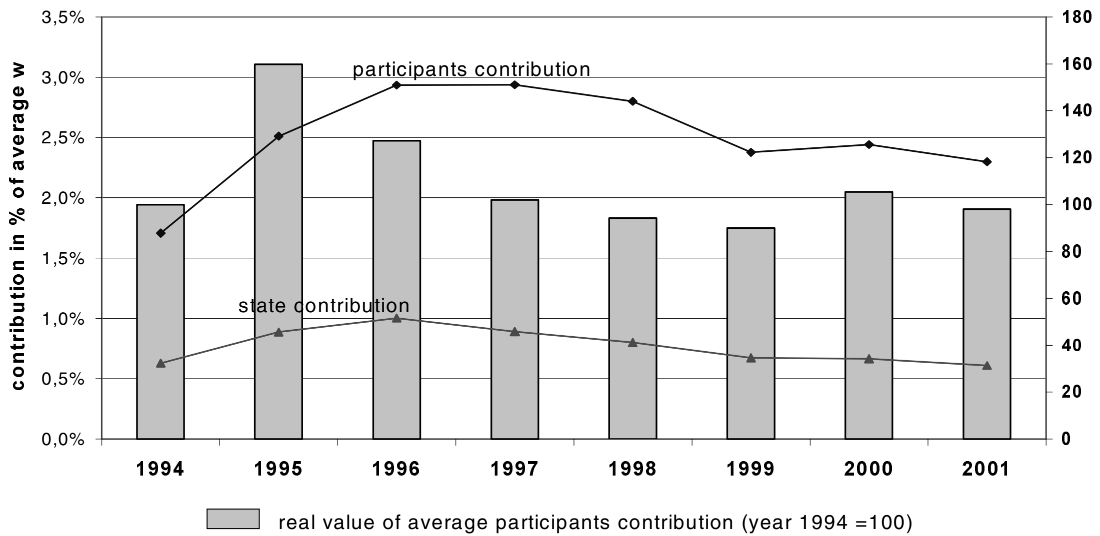


Figure 17.6. Development of real value of average contribution and of ratio of average contribution to average wage



Chapter 18

CONTRIBUTION EVASION: IMPLICATIONS FOR SOCIAL SECURITY PENSION SCHEMES[1]

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Introduction

Failure of participants to comply with their contribution obligations to social security schemes, is a problem which threatens the legitimacy of the schemes, the adequacy of the social protection of persons whose due contributions have not been paid, and the financial viability of defined benefit schemes. If widespread evasion results in generally inadequate pensions, governments may be obliged to supplement them. While evasion is a serious problem, it receives little attention in the social security literature. Generally, evasion of contribution obligations, by employers and workers, is illegal, hence, statistics on evasion are rare, and evidence is principally anecdotal, or derived from other data. Avoidance of contributions, for example, by seeking early, or disability, retirement, or employment that is not covered by the scheme, is legal. High levels of evasion, and avoidance, can indicate low public credibility of a social security scheme, and reflect on the quality of governance of the scheme, and the efficiency of scheme administration.

It is important to distinguish between coverage − those persons who, by law or regulation, are participants in a social security scheme, and are generally obliged to contribute to it − and compliance, which refers to the extent to which covered persons meet their contribution obligations. A social security scheme can only function with the support of its participants (Rofman and Demarco, 1999, p. 2). Extending mandatory coverage to categories of workers, who may not be disposed to participate in the scheme (*i.e.* to contribute), and whose participation cannot be effectively enforced, may bring political rewards, but it can bring a scheme into disrepute, if their participation is illusory. Typical examples of these categories include self-employed workers (including farmers and fishermen), and domestic workers. If evasion of contributions becomes widespread, and is tolerated, a mandatory social security scheme can effectively become a voluntary scheme. This paper focuses on compliance of employed persons. Compliance of self-employed workers involves additional, and more complex, problems. For a summary of these, see ILO (2000, pp. 198-199).

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1. Reprinted with permission from the *International Social Security Review*, Vol. 54, No. 2, October-December 2001. Based on a paper presented to the Third APEC Regional Forum on Pension Fund Reform, Bangkok, 30-31 March 2000.

For employed persons, social security contributions are, normally, withheld from their wages by their employers, who are legally responsible to remit the contributions, along with any employer contributions, to a collection agency. Employers are subject to penalties, if they fail to make the remittances within specified time limits. An employee's evasion of social security contributions normally requires collusion with the employer and, sometimes, the employer colludes with social security scheme inspectors.

In social security schemes where employers contribute, there is an incentive for an employer not to contribute, in order to reduce labour costs. When the employer opting for this approach is the government or a state enterprise, the demonstration effect encourages other employers to follow the example set by the government. The principal incentive for workers to evade contributions, is to increase their disposable income. Evasion of social security contributions is possible, if the social security organisation tolerates evasion, or if it does not have the authority, or the resources, to enforce compliance with the statutory contributory provisions. The problem of evasion warrants greater attention, as does the development of strategies to promote compliance.

Principal types of evasion

Employers can evade contributions, by under reporting employees who should be covered by the social security scheme, for example, by designating employees as workers who are not required to contribute (*e.g.* casual, part-time, or temporary workers, or contractors), thereby informalising them. They can also evade their contribution liability, by under reporting the earnings subject to contribution of workers, whom they have registered with the scheme. Employers can delay remitting contributions to the social security scheme, contrary to the scheme regulations; or, in the most insidious case, employers can fail to remit contributions, which they have withheld from their employees.

Provisions of a scheme may facilitate evasion. For example, an employee may claim to be self-employed, if coverage of self-employed workers is voluntary. Where employers must have a minimum number of employees (or turnover), for coverage under a scheme, they may contrive to keep the number of employees below this number. Social security cash benefits are designed to replace a portion of the regular income of a worker, and it is this regular income, on which contributions are based. The portion of regular income, in a worker's wages, can be reduced by exaggerating overtime compensation, and allowances (*e.g.* for travel).

Workers may avoid contributions, by opting for early retirement, or seeking a disability pension, or by working in the informal sector, which is not covered by social security. This can result in labour market distortions, and a loss of potential domestic saving (Manchester, 1999, pp. 296-299). In many countries, especially those with high unemployment, it is not clear that avoiding social security contributions, and other taxes, are sufficient inducements to joining the informal sector, given the typically uncertain income, and dubious security, of informal sector employment.

Reasons for evasion

Aside from seeking to reduce their labour costs, employers may evade paying social security contributions, due to the administrative complexity of compliance procedures. Separate contribution assessment, and collection arrangements, for different social security benefits (and for income tax), and multiple collection agencies, to which contributions must be allocated, and remitted, make compliance more difficult, and evasion more attractive, and practicable. The records of some employers, especially in small establishments, are sometimes inadequate for them to determine the contributions payable. The proclivity of an employer to evade, also depends on the employer's

assessment of the risk of being caught, and should the employer be caught, the severity of the consequent financial penalty ,and damage to the employer's reputation.

Current consumption needs can lead workers to seek to evade paying social security contributions, especially when the contribution rate is high. Poverty, temporary financial hardship and, particularly for young workers, expenses associated with family responsibilities, are more immediate, and pressing, than paying contributions for a future retirement benefit.

Myopic behaviour − placing too low a value on future retirement consumption needs − led to state intervention to set up retirement benefit schemes, both to avoid the consequences of inadequate provision for retirement by myopic individuals, and the burden which they would create for prudent persons, who, in a modern state, would be called upon to support them (Thompson, 1998, p. 28). Myopic behaviour is reinforced, when individuals perceive that they are unlikely to survive to receive retirement benefits, or when inflation discourages saving. Such short-sighted behaviour, and current consumption needs, can provide strong motivations for workers to evade their contribution obligations (World Bank, 1994, pp. 319-320).

Some defined benefit schemes contain design features that encourage evasion. For example, in the 1970s, one public scheme (which eventually became unsustainable), provided an old-age pension at age 65, after ten years of contributions, equal to 50% of the highest three years' earnings (adjusted for cost of living inflation) after age 55, and the pension was increased by 1% for each year of service after ten. Five of the years of service had to be in the eight years prior to retirement. Thus, after ten years of contributions, the increment in the pension was marginal. The scheme was open to strategic manipulation by workers, who could organise their employment to maximise their expected pensions, and minimise their contributions, and this was reflected in high rates of contribution evasion.[2]

In defined benefit (DB) pension schemes, the retirement pension is often calculated according to a formula, which links a worker's earnings near retirement, and the period during which the worker contributed to the scheme, hence, the link between benefits and contributions is not transparent in many DB schemes. In defined contribution (DC) schemes, the periodic payments throughout retirement, depend on the accumulated amount in a worker's individual account at retirement. It is expected that the close link between benefits and contributions, in DC schemes, will reduce contribution evasion, since evasion directly results in lower pensions (James, 1998, p. 455). This rational response does not seem to be reflected by high levels of compliance in DC schemes, which have replaced DB schemes (Schulthess, 1998, p. 139; Mesa-Lago, 1998, p. 782; Holzmann *et al.*, 1999, p. 9). In Gillion *et al.* (2000, p. 255) it is noted that, in several countries in South America, only around half of the labour force participates in the mandatory DC scheme. Myopic behaviour, and current consumption, needs still seem to predominate over prudent saving for retirement.

Government minimum pension guarantees can create a moral hazard, for contributors who may decide to forego contributions, in order to take advantage of the guarantee. Eliminating a guaranteed minimum pension would remove the potential moral hazard, but would not solve the problem of providing retirement income support for persons whose pensions, for whatever reason, are low.

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2. One reason for basing benefits on final average earnings is simplicity of administration. Before modern information technology methods were introduced, maintenance of annual records of contributory earnings over a participant's entire working career was beyond the administrative capacity of many schemes. In some DB schemes that require extensive historical records in order to calculate a benefit (and in some provident funds), a retiring participant is expected to produce his/her own service (or contribution) records when applying for a benefit.

Workers may try to evade their contribution obligations, if they lack confidence in the social security scheme, for example, if the legitimacy and equity of the scheme are being challenged. A few workers will reckon, and others may be persuaded, that they can obtain a better rate of return on their contributions elsewhere, thereby encouraging them to evade. If evasion is widespread, and creates little opprobrium, and enforcement is weak, evasion becomes an easy option. Even if workers wish to comply with the contribution conditions, they may be reluctant to report a defaulting employer, since, if their anonymity is not maintained, the worker risks retaliation (loss of employment), and if enforcement is weak, reporting the employer may be futile.

Effects of evasion: why governments should care about compliance

Evasion creates inequities between employers, who meet their contribution obligations, and those who do not, and, similarly, between workers who contribute, and those who do not. The effect of evasion on the solvency of DB and DC schemes differs. When evasion is due to an employer failing to remit contributions withheld from employees, in most DB schemes (but not DC schemes), participants who have been defrauded receive credit for the service and earnings represented by the contributions, whether the scheme can recover the contributions from the defaulting employer, or not. In a DB scheme, evasion can result in lower *real* replacement rates, and/or a higher contribution rate, than would otherwise be required to pay pensions. When earnings are under reported, the benefit formula, and/or minimum pension provisions, can produce deceptively high replacement rates, relative to reported earnings. A DB scheme (*i.e.* its current and future members), and ultimately the government, bear the risk that evasion will result in insufficient income to pay benefits, and that a transfer from general revenue will be necessary. This may motivate social security organisations, and governments, to enforce compliance with DB scheme contribution conditions. This motivation is not present in DC schemes.

In DC schemes, individual participants bear the risk that their benefits will be inadequate. Evasion results in lower periodic payments during retirement, but neither the scheme (nor account managers), nor the state, is legally responsible for this result of evasion. However, the consequent recourse to general revenue financed minimum pension guarantees, and political pressure from retired persons, will, surely, make it inevitable that the state will be called upon to provide retirement income support. Increased attention to enforcing compliance can reduce this potential burden.

Minimum pensions

In some countries, members of DC individual accounts schemes are guaranteed minimum pensions by the government. Whenever necessary, pensions of participants who have contributed for a specified minimum period, are supplemented, up to the level of a guaranteed minimum pension. Table 18.1 indicates minimum pension provisions in selected countries.

In Chile, where after 20 years of contributions, the minimum pension is around 25% of the average wage, it is not clear that the minimum pension guarantee provides significant inducement to evade contributions. However, participants may decide to rely on the minimum pension (presumably, along with other savings), to finance their retirement, or they may conclude that continuing to contribute is not going to produce a pension significantly higher than the minimum pension. Arenas de Mesa (1999, pp. 12-14) estimates that 52% of pensioners in the private DC individual accounts system in Chile, will qualify for minimum pension supplements, and that the cost of minimum pensions will rise from around 0.04% of GDP in 1999 to 1.3% of GDP in 2037.

Minimum pensions are paid from general revenue. There is no pooled fund from which they may be paid, as in a DB pension scheme. Arenas de Mesa (1999, p. 33) proposes establishing a pay-as-you-

go (PAYG) DB scheme to finance minimum pensions. If a significant proportion of retired persons are receiving minimum pensions, the increasing number of pensioners, and their political influence, can lead to irresistible pressure on governments, to increase the levels of minimum pensions.

Another potential result of evasion, is that workers may be obliged to delay their retirement (provided, of course, they can find employment), not because they wish to continue working, but because their DC scheme pensions are too small to support them, and their dependants. Contribution evasion may thus lead to an increase in the age when workers withdraw from the labour force, a desirable result (albeit for a perverse reason), in countries where significant reductions in the labour force, relative to retired persons, are projected. The affected workers will have employment income while they continue working, and the retirement period, during which they must rely on their pensions will be reduced, thereby resulting in larger pensions.

Measuring evasion

Workers' evasion is generally considered to be greatest among self-employed workers, and young, low-paid, domestic, casual and part-time workers. Evasion of contribution obligations is normally illegal; consequently, consistent data on the extent of evasion by participants (or workers who should participate) in a scheme, are not available. Evasion is prevalent among small employers, employers in the informal sector, and employers who are experiencing financial difficulties, categories for which reliable statistics are difficult to collect. A social security scheme usually has statistics on the number of registered employers contributing regularly to the scheme. Among the types of evasion by employers registered with a scheme are: i) failure to register eligible workers, ii) under reporting earnings, and iii) delay in remittances, or failure to remit. The scheme will normally have data only on collections, the third item.

If the coverage of a scheme is broad, an estimate of the amount of contributions which have been evaded, the contribution gap, can be made by taking the difference between the contribution income received, and the product of i) the estimated annual average number of employed persons times, ii) the estimated annual average covered wage times, iii) the contribution rate.

Employers' compliance with contribution regulations, in countries where contributions are collected along with income taxes (*e.g.* Canada, US), and in Japan, where social security contributions and taxes are collected separately, is considered to be high. In the US, the total contributions not paid voluntarily as a percentage of the estimated "true" liability, was estimated to be 10.3% in 1997. For employed persons, the percentage was 4.2%, and for self-employed persons, it was 58.7% (Manchester, 1999, pp. 302-303). In Japan in 1996, 98.6% of employers who were required to contribute to the scheme covering employees, did so. On the other hand, in 1997, 7.5% of those who should have registered with the scheme covering self-employed, and unemployed, workers, failed to register, and 8.2% of those who had registered, had not contributed in the past two years (Gillion *et al.*, 2000, p. 253).

In 1996, the Singapore Central Provident Fund, which collects contributions directly, reported that the default rate for employers, who failed to pay the monthly contributions on time, was 1.4% (Central Provident Fund Board, 1996, p. 43). In 1996 and 1997, the Employees Provident Fund of Malaysia reported that the percentage of defaulting employers was 4% (Employees Provident Fund, 1997, p. 22).

In the Russian Federation, where the financial crisis in mid-1998 exacerbated structural crises associated with economic restructuring, Cichon (1999) estimates that the contribution gap of the Pension Fund of the Russian Federation grew from 26% of contributions, due in 1997, to 53% in 1998.

Table 18.2 shows statistics on the ratio of contributors to participants (affiliates), for several reformed schemes in Latin America. These statistics reflect a number of factors, of which compliance is only one, and they must be interpreted cautiously (Mesa-Lago, 1997, pp. 420-421). The following caveats should be borne in mind:

- Participants may have withdrawn from the covered labour force, yet may still be included in the potentially active participants. Clearly, if participants who have withdrawn from active coverage are considered to be eligible contributors, the ratio of contributors to participants will decrease. Failure to remove participants who have become inactive, can eventually lead to the number of participants exceeding the labour force. [See Arenas de Mesa (1999) with respect to Chile.]

- In individual accounts DC schemes, participants may be registered with more than one pension fund manager, and administrative problems may complicate identification of participants (especially those who switch managers), and employers may delay remitting contributions.

- Self-employed participants, who are obliged to contribute, have notoriously low compliance rates. If self-employed workers are a significant portion of the covered labour force, this can result in a low overall compliance rate. Queisser (1998, p. 107) reports that in Argentina, where self-employed workers are obliged to contribute, 70% of them failed to comply.

Schmidt-Hebbel (1999, p. 10) observes "... coverage of affiliates – that comprise both active contributors, and non-active members – is very different from coverage of contributors. The latter number ranges from a half to two-thirds of affiliates. The causes of this discrepancy include varying degrees of evasion of contributions, large and time-varying degrees of labour informality, and large variations in the composition of the officially measured labour force, and people moving in and out of the labour force. A case in point is Chile, where 100% of the labour force is affiliated with the second pillar scheme, but only 56.2% are active contributors. In this country, most of the difference is due to independent, and informal, sector workers, as the ratio of active second pillar contributors to dependent workers [*employees*] is close to 90%" (italics added).

Arenas de Mesa (1998, Table 4) separates Chilean employed persons from the self-employed, for whom coverage is voluntary. In 1998, the ratio of contributors to employees was 66%, and for the self-employed, it was 4%.

It is clear that the definition of coverage and measurement of compliance can lead to statistical complications, and inconsistencies. The relationship between an individual's employment status and coverage, and the individual's obligation to contribute, can be summarised:

Employment status of individual	Contribution obligation
1. Covered:	contributor
1a. active participant	
1b. inactive participant	non-contributor (possibly can contribute under 2)
2. Voluntary coverage	optional contributor
3. Not covered	non-contributor
4. Pensioner	non-contributor

Inactive participants include persons who have temporarily, or permanently, withdrawn from covered employment (due, for example, to unemployment, retirement or, in the case of females, maternity), generally with acquired benefit rights arising from prior periods of active participation. Measurement of compliance refers to the ratio of contributors to active participants in category 1a.

Evasion and financial projections

Defined benefit schemes

While the true rate of compliance may be difficult to measure, it is clear that it is below 100%. In actuarial projections of contributions to DB schemes, this is taken into account by assumptions regarding the density of contributions where,

$$\text{Density of contributions} = \frac{\text{period during which contributions are paid or credited}}{\text{total potential period of contributions}}$$

This definition takes into account legitimate periods, during which a participant is not liable to contribute, evasion by the participant's employer, due to failure to register eligible workers, and evasion by the participant. If significant benefit rights are acquired in a DB scheme after relatively short contributory periods, a density of benefits which is higher than the density of contributions, can be applied. Different density assumptions can be made, by sex and type of employment. This definition of contribution density does not take into account under reporting of earnings subject to contribution.

An alternative density definition, which incorporates periods when contributions are not paid ,and under reporting of contributory earnings, is:

$$\text{Density of contributions} = \frac{\text{annual earnings on which contributions are paid}}{\text{annual earnings on which contributions are payable by a full-year contributor.}}$$

Defined contribution schemes

Estimates of DC scheme individual account balances are readily constructed, and there are no generally accepted standards regarding the assumptions which must be made concerning interest rates, and rates of wage growth during the active (contribution payment) period. Density is generally ignored (as is mortality), during the active period. Projections may be made over an active period of 40 years (*e.g.* age 20 to 60, or 25 to 65). Few participants will have a full 40 years of contributions and, consequently, the projected individual account balances at the end of 40 full years of contributions can be deceptive.

For example, in a DC scheme, assuming an average annual 2% real growth in wages, and 4% real interest earnings, after 40 full years of contributions, at a contribution rate of 10%, the balance in the account will be about six times the wages in the last year. Assuming an (arbitrary) annuity factor of 12 (*i.e.* 12 units, at retirement, produce a life annuity of one unit per annum), then the balance in the account results in a life annuity equal to 50% of the wages in the fortieth year. A greater difference between the assumed interest rate, and wage growth, will produce a larger annuity, and conversely. This relationship between the assumptions, and the fact that projections over 40 years may be

sufficiently robust for a group, but are unlikely to apply to any specific member of the group, are largely ignored. In this example, the effect of density of contributions is also ignored.

A worker who experiences intermittent periods of unemployment may have a density of contributions of 80%. If it is assumed that periods of unemployment are uniformly distributed over 40 potential years of contributions, then the annuity is reduced from 50 to 40% of the wages, in the fortieth year. But periods of unemployment are often concentrated, and prolonged. Suppose a worker continues studying, or cannot find employment, and does not enter the scheme until the ninth year, and thereafter contributes regularly for 32 years.[3] Again, the density of contributions is 80 %, but in this case, the annuity will be 37% of wages in the fortieth year. At the other end of a worker's career, if a worker contributes for 32 years, and is unemployed for the last eight years before retirement, the density is again 80%, but the annuity is 43% of wages in the fortieth year. While an 80% density of contributions may be a reasonable assumption for workers who experience involuntary unemployment, the density of contributions for workers who evade contributions can be very much lower. It is noteworthy that, while in a DB scheme which uses a final average earnings benefit formula, it is important to be in contributory employment during the period near retirement, so the earnings applied are high, in a DC scheme, the operation of compound interest makes it important to commence contributions early. [For a mathematical treatment of density of contributions, see Iyer (1999).]

Combating evasion

Evasion of social security contributions is not only a question of employers' seeking to reduce their labour costs, or workers' preference for current consumption, or the other factors heretofore mentioned. If social security organisations (and governments) rely principally on education and persuasion, to encourage compliance, rather than on effective enforcement, it is not surprising that contributors seek to evade their contribution obligations.

Social security organisations can combat evasion, but they must have the *statutory authority* required for effective enforcement of contribution conditions. If government does not grant a social security organisation the necessary authority, the commitment of the government to the social security programme is in question, enforcement will be hampered and ineffective, and benefit expectations will not be met. Social security schemes need:

- The *right to inspect* employer records, and unfettered access to ancillary information, such as an employer's bank statements, income tax returns, etc., from which estimates of the number of employees, and the wage bill, can be made, and compared to social security registrations, and contributions paid. Confidentiality should not be invoked, in order to conceal, or abet, evasion of social security contribution obligations; and

- The *right to assess and collect contributions due and unpaid, and assess enforceable penalties,* with social security debts having priority over other creditors, the possibility of attachment of employers' assets, etc.

Armed with statutory authority, social security organisations can take a number of steps to enforce compliance. They can *streamline administrative procedures,* by simplifying contribution regulations, and reporting and remitting procedures. Modern information technology facilitates this. Clearly, a unique registration number for each employer, and each participant, is necessary (however,

3. It is assumed that the worker's wages at entry are the same as those of workers who have been in the scheme for eight years. This is unlikely to be true in practice.

for worker contributors, this fundamental requirement causes many schemes much difficulty). Contribution conditions for different social security benefits, administered by different schemes, can be harmonised, and consolidated.

In some systems, workers have been empowered to make their own choices (*e.g.* select fund managers), but they, generally, do not have the information necessary, nor the capacity, to evaluate and analyse it, in order to make informed decisions. In their dilemma, there is no shortage of professional advisers, and salespersons, to assist them. The switching of fund managers, which results, complicates administration, and can create, or abet, non-compliance with contribution provisions.

According to Daykin (1998, pp. 36-37) "some would place a high premium on having consumer choice. It is difficult to be against choice, but the essential factor, with pensions, is to ensure that the consumer has adequate safeguards, since the issues are rather too complicated for most people to grasp fully the nature of the choices with which they are faced. Although it may sound paternalistic, it is sometimes better to limit the number of choices, in order to ensure that everyone receives a reasonable level of pension".

They can strengthen enforcement through focused, and timely, inspections. Effective enforcement requires timely verification of employer returns, and prompt investigation of possible discrepancies. There must be sufficient, well-trained, inspectors, who are adequately remunerated, so as to ensure their probity, and resources for them to undertake inspections. Enforcement activities are expensive, but they are a legitimate, and necessary, expense of a social security scheme. In Malaysia, at the end of 1997, there were nearly 300 000 registered employers in the Employees Provident Fund, and during the year, the Fund inspected just over 100 000 registered, and non-registered, employers (Employees Provident Fund, 1997, pp. 11, 22). In Singapore, 20% of employers' records are inspected each year (Wu, 2000).

They can initiate and enforce, punitive, but realistic, administrative penalties for evasion. Penalties should not be so severe, that they are unlikely to be respected, or applied successfully, or sustained by the courts. In the Philippines, 1997 legislation provides that non-registration of a self-employed person, failure of an employer to deduct the correct contributions, and remit them, or submission of a false claim for benefits, can result in six to twelve years imprisonment, and a fine (Social Security System, 1997, p. 29). The severity of the penalty leads employers, whose non-compliance is detected, to settle their arrears.

They can undertake public relations campaigns, to encourage compliance. Through the benefits they provide, and the efficiency of their operations, DB schemes must convince workers that, despite allegations that they are unsustainable, they are reliable providers of retirement income. A punitive approach, which in some countries has promoted compliance, is publicising (and prosecuting), employers for evasion (or maintaining the threat to do so).

They can report regularly (annually at least) to workers on contributions paid by them and on their behalf so that workers can verify that their contributions have been properly remitted and recorded, and at the same time they are reminded of the benefit rights they are acquiring.

They can collect pension scheme contributions, along with contributions for other social security benefits, for example medical care, for which the needs of workers, and their families, are more immediate; hence workers are more likely to comply, than for retirement benefits alone. In Germany, which does not have a serious evasion problem, pension contributions are collected by the sickness insurance funds. This procedure can increase administrative efficiency, and reduce employers' reporting burdens.

They can enforce compliance, indirectly, through realistic regulations which, while not inhibiting commerce, require that an employer be certified by the social security scheme, to be in good standing before the employer can be issued, or reissued, a business licence, bid on government contracts, receive an export licence, etc.

They can remedy scheme design deficiencies, that encourage evasion. For example, DB schemes can modify provisions, that encourage strategic manipulation of contributory periods, in order to maximise benefits, and minimise contributions.

They can co-ordinate verification, and enforcement activities, with the tax collection agency, where there are separate social security and income tax collection agencies.

They can declare amnesties, to encourage evading employers to comply in the future. In the Philippines, the Social Security System has offered several amnesties to delinquent employers, for example, from May to November 1997 (Social Security System, 1997, p. 29). Frequent amnesty declarations may not promote compliance, since employers may continue to evade, in anticipation of a subsequent amnesty.

It is noteworthy that the Singapore Central Provident Fund, which has, in effect, adopted a policy of "zero tolerance" of evasion, employs many of these methods, to achieve its enviable record of contribution compliance (Wu, 2000).

Social security schemes can avoid creating expectations, which cannot be fulfilled, and thereby bringing themselves into *disrepute by judiciously extending their coverage.* For example, extending compulsory coverage to self-employed persons seems to be a logical extension of social security, to a sector of the labour force that needs protection, and can have the capacity to finance it. But self-employment is not clearly defined, and, everywhere, persons deemed to be self-employed have notoriously poor records of compliance with social security contribution obligations.[4] Consequently, extension of coverage to self-employed workers can be futile, unless the categories of self-employment are carefully selected, and defined, and the administering body has the will, and the capacity, to enforce compliance. Unless an extension of coverage is implemented effectively, a social security scheme risks jeopardising its legitimacy.

Private DC individual accounts managers

With respect to contributions which workers are obliged by law to remit (through their employers), fund managers, to whom the contributions are payable, tend to behave in much the same manner as insurance companies, which receive premiums from persons they insure, and mutual funds (or unit trusts), which receive deposits from investors. In the case of insurance companies, the acquisition expenses for new policyholders are amortised over a number of years. Should a new policyholder cease paying the premiums due early in the contract period, the agent who sold the policy is debited the commission which the agent received. An insurance company's enforcement effort is normally limited to encouraging the agent to persuade the insured person to continue paying the premiums; a usually unsatisfactory endeavour, since agents are generally more successful at selling policies, than maintaining them in force. There is no legal liability for an insured person to continue paying premiums on an insurance policy, and the insurance company has little motivation to devote

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4. The distinction between employment and self-employed workers is discussed by Williams (1997), and other aspects of coverage of self-employed and informal sector workers are dealt with in the *International Social Security Review* (ISSA, 1999).

resources to persuading the insured person to pay the premiums; instead it limits its losses on the lapsed policy, by "writing it off".

This approach is not appropriate for a statutory social security scheme. Participants do not have the option of lapsing their mandatory contributions. Contributions have to be collected, and enforcement activities, by the body that is responsible for collecting contributions, must deter evasion. There is little incentive for private fund managers to devote resources to compliance, since evaders are predominately individuals, whose contributions would be small, and generate relatively high transaction costs. A centralised collection agency may pursue a more diligent enforcement policy. No matter how enforcement is undertaken, it is a legitimate, and significant, expense, of a social security scheme.

Collection systems

"In most countries, social insurance contributions for mandatory pension systems are collected by a public agency. Marginal costs are lowest, when collection of contributions can piggy-back onto existing income-tax collection systems. There are good reasons for this. An income-tax collection agency has extensive infrastructure in place, that can not only collect contributions, but also perform important verification, oversight, and enforcement functions" (Heller and Gillingham, 1999, p. 4). Despite the apparent merits of a joint collection system, separate collection systems for social security contributions, and income tax, are maintained in most countries. In countries which have introduced DC individual accounts schemes with private fund managers, contributions are paid directly to the fund managers (*e.g.* Chile, El Salvador, Peru) or to a central collection agency, which transmits them to the fund managers selected by the contributors (*e.g.* Argentina, Mexico, Uruguay).

It was once held that social security contributions, and income tax, should be collected separately, since workers were more disposed to pay social security contributions that conferred rights to identifiable benefits, than to pay income tax; consequently, the two deductions from wages should not be confused. Even with separate collection systems, workers who might be prepared to pay their social security contributions, but were determined to evade income tax, would evade both, if effective arrangements for sharing information between the collection systems were in place.

Social security contributions may be payable from a lower income threshold, than the threshold for income tax. Hence, a joint collection agency might devote less attention to low-paid workers, who are liable to pay social security contributions, but not income tax, thereby abetting low-paid workers' evasion of their social security contributions.

The evident economies of scale, and efficient enforcement, that should be possible with a unified collection system, cannot materialise, unless two critical conditions are met:

- There must be a strong fiscal administration. (In some countries, it is claimed that the social security organisation collects contributions more efficiently, than the tax collection agency collects income taxes.)

- The social security organisation, and the participants in the scheme, must be confident that a joint collection body will act solely as an agent who receives, and transmits, social security contributions to the social security organisation, without delay, or diversion. (Since the joint collection body is, generally, a government body, in countries where governments face chronic budget deficits, this confidence can be difficult to build. Also, the concept of "agency" may be poorly understood in former command economy

countries, where the tax collection authority is unaccustomed to crediting revenues anywhere, other than to the state budget.)

If these conditions are fully met, a social security organisation, which changes to a joint collection system, could expect an improvement in compliance (McGillivray, 1997, p. 62).

With respect to collection systems, it is tempting, but inappropriate, to identify best practice. As Ross (1997, p. 12) states "a basic proposition that may sometimes be lost sight of ... is that 'real circumstances' in any country should determine the nature of the administrative arrangements that are utilised to collect social contributions and taxes". Real circumstances include the size, and characteristics, of the population of the country, the resources available to the government (financial, personnel, information technology), political time frames, and other constraints, and the national cultural, and social, situation. Ross concludes, "Administrative arrangements that do not take adequate account of real circumstances generally fail to operate properly".

While the focus may be on compliance with social security contribution obligations, it must be borne in mind, that participants in a social security scheme are citizens, or residents, of a state, and generally, also taxpayers. For a modern state to function, it is necessary for the polity to respect the statutes and regulations of the state. In the long run, an effective joint social security contributions, and income tax collection agency, can benefit society as a whole.

Conclusion

Compliance of participants with social security contribution conditions, is a subject that has received little attention. The opposite of compliance, evasion of social security contributions, is generally illegal, and social security administrators are sometimes reluctant to admit they face compliance problems. Hence, while the coverage of a social security scheme may be well-defined, the extent to which covered persons are actually participating in the scheme is not, and few statistics are available. But compliance is important. No social security scheme, reformed or not, DB or DC, publicly, or privately managed, funded or PAYG, and no matter how well it may be designed, will achieve its objectives, if participants do not comply with the contribution conditions. Non-compliance creates the risk that covered persons who evade their pension scheme contribution obligations will have inadequate pensions, and that the state will be called upon to remedy the shortfall. The principal causes of evasion, and possible remedies, and alternative contribution collection systems, have been indicated; but the extent of contribution evasion results from national circumstances, and appropriate measures, which promote compliance, depend on appropriate national initiatives, and the allocation of the resources necessary to implement them.

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Table 18.1. Minimum pension provisions in selected countries

	Minimum contribution Period (years)	Amount
Argentina*	30	Discretionary
Chile	20	=25% of average wage
Colombia*	22	One minimum wage = 60% of average wage
Mexico*	25	Mexico City minimum wage = 40% of average wage
Uruguay*	35	Discretionary

* Applies to both public DB scheme and private DC individual accounts schemes.

Source: Queisser (1998), pp. 67-68.

Table 18.2. Ratios of contributors to affiliates in DC individual accounts schemes in Latin America

		Queisser (1998)	Mesa-Lago	
	EAP covered (in %)	Contributors/Affiliates	Contributors/ Affiliates (in %) 1997	Contributors/ Affiliates (in %) 1998
Argentina	80	49	52	49
Bolivia	–	–	–	–
Chile	98	56	54	56
Colombia	30	67	50-53	
Mexico	33	65	–	65
Peru	32	44	45	
Uruguay	70	Na	72	61

EAP = Economically Active Population (coverage refers to the public and private systems).

Source: Queisser (1998), Table 4.1, p. 56 and Table 5.1, p. 71; Mesa-Lago (1997), p. 420 data for 1996; Mesa-Lago (1998), Table 3, p. 792 new data.

GLOSSARY

AOW	National Pension Scheme (The Netherlands)
BfA	Federal Insurance Institute for Salaried Employees (Germany)
CBOS	Polish Statistical Office
CEE	Central and Eastern Europe
DB	Defined Benefit
DC	Defined Contribution
ECOFIN	Economic and Financial Affairs Council
EFTA	European Free Trade Associationa
EPC	Economic Policy Committee
EMS	European Monetary System
EMU	European Monetary Union
EU	European Union
EUR	Euro
FEP	Bridging Pension Fund (Poland)
FERI	Financial and Economic Research (Germany)
GDP	Gross Domestic Product
HUF	Hungarian Florin
IFIs	International Financial Institutions
ILO	International Labour Organisation
IMF	International Monetary Fund
INPRS	International Network of Pension Regulators and Supervisors
INPS	Istituto Nazionale della Previdenza Sociale (Italy)
ISSA	International Social Security Association (Geneva)
LFMI	Lithuanian Free Market Institute
MLSAF	Ministry of Labour, Social Affairs and the Family (Slovak Republic)
NC SR	National Council Slovak Republic
NDC	Notional Defined Contribution
NSSI	National Social Security Institute (Bulgaria)
OKS	Civic Conservative Party (Slovak Republic)
PAYG	Pay-As-You-Go
PPC	Pension Provision Contract (Germany)
PPF	Private Pension Fund (Latvia)
PTE	Pension Fund Society (Poland)
SEKIF	Registry of Accounts and Funds (Poland)
SIA	Social Insurance Agency (Slovak Republic)
SKK	Slovak Crowns
SPIC	Supplementary Pension Insurance Company (Slovak Republic)
SPS	Supplementary Pension Schemes (Slovak Republic)
TEC	Treaty establishing the European Community
TEU	Treaty establishing the European Union
UNFE	Superintendency of Pension Funds (Poland)

USAID	United States Agency for International Development
USD	United States Dollars
ZPIZ	Pension and Invalidity Insurance Institute (Slovenia)
ZUS	Social Security Institute (Poland)

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Table 18.1. Minimum pension provisions in selected countries

	Minimum contribution Period (years)	Amount
Argentina*	30	Discretionary
Chile	20	=25% of average wage
Colombia*	22	One minimum wage = 60% of average wage
Mexico*	25	Mexico City minimum wage = 40% of average wage
Uruguay*	35	Discretionary

* Applies to both public DB scheme and private DC individual accounts schemes.

Source: Queisser (1998), pp. 67-68.

Table 18.2. Ratios of contributors to affiliates in DC individual accounts schemes in Latin America

	EAP covered (in %)	Queisser (1998) Contributors/Affiliates	Mesa-Lago Contributors/ Affiliates (in %) 1997	Contributors/ Affiliates (in %) 1998
Argentina	80	49	52	49
Bolivia	–	–	–	–
Chile	98	56	54	56
Colombia	30	67	50-53	
Mexico	33	65	–	65
Peru	32	44	45	
Uruguay	70	Na	72	61

EAP = Economically Active Population (coverage refers to the public and private systems).

Source: Queisser (1998), Table 4.1, p. 56 and Table 5.1, p. 71; Mesa-Lago (1997), p. 420 data for 1996; Mesa-Lago (1998), Table 3, p. 792 new data.

GLOSSARY

AOW	National Pension Scheme (The Netherlands)
BfA	Federal Insurance Institute for Salaried Employees (Germany)
CBOS	Polish Statistical Office
CEE	Central and Eastern Europe
DB	Defined Benefit
DC	Defined Contribution
ECOFIN	Economic and Financial Affairs Council
EFTA	European Free Trade Associationa
EPC	Economic Policy Committee
EMS	European Monetary System
EMU	European Monetary Union
EU	European Union
EUR	Euro
FEP	Bridging Pension Fund (Poland)
FERI	Financial and Economic Research (Germany)
GDP	Gross Domestic Product
HUF	Hungarian Florin
IFIs	International Financial Institutions
ILO	International Labour Organisation
IMF	International Monetary Fund
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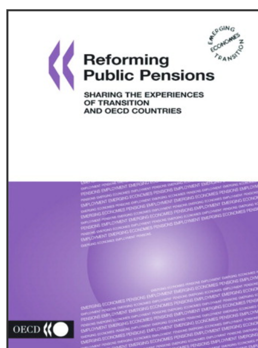

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