The creation of personal retirement accounts in Slovakia

By Jan ORAVEC

QUICK FACTS ABOUT THE PROCESS OF THE SLOVAK PENSION REFORM

June 10, 2002: The F. A. Hayek Foundation organizes the first international conference on the need for pension reform in Slovakia. José Piñera is invited and delivers an inspiring presentation about the new pension paradigm of personal retirement accounts. Many politicians are present because of the upcoming elections, including Ludovit Kanik, at that time a leader of the Democratic Party, and later Labour Minister implementing personal accounts.
September 25-26, 2002: Parliamentary elections give reform oriented parties an opportunity to form a new government again
November 4, 2002: The new government adopts a declaration committing itself to personal retirement account
2003-2004: The necessary legislative framework is prepared, a parliamentary delegation visits Chile, and the law is approved.
January 1, 2005: The first day of an 18-month period giving Slovak citizens the opportunity to opt for personal retirement accounts.

QUICK FACTS ABOUT THE FIRST RESULTS

June 15, 2005: the first billion Slovak crowns of personal savings are accumulated at individual accounts.
August 15, 2005: 1 million citizens opt for the personal savings accounts.
February 1, 2006: SKK 10 billion of pension savings accumulated at individual accounts.
May 18, 2006: accumulated private pension savings exceed 1 % of GDP.
June 30, 2006: 1.5 million, or 54 % of eligible citizens, join the new system in its first 18 months and accumulate on their accounts 17.3 billion of crowns in pension savings.

I. INTRODUCTION

The story of the creation of personal retirement accounts in Slovakia cannot be told simply by presenting plain facts, irrespective how impressive the quick facts above are. There are two major reasons for that. Firstly, the pension reform itself, an otherwise unprecedented achievement needs to be put within a more general framework of a country making from the beginning of the 1990s a very difficult economic, social, and political transition from centrally planned economy, ruled by a communist totalitarian state, towards a democratic society and a market economy. Secondly, one cannot get a full picture without the personal stories of many individuals whose personal views, thoughts, visions, attitudes, and decisions were of crucial importance in terms of their impact on the overall result.

These two observations are fully projected into the following personal reflections upon the story of the creation of the personal retirement accounts in Slovakia. Firstly, the text is divided into three time periods, each identifying its own specific challenges and describing the strategies to meet them 1990-1998 was a period of intense and far-reaching overall political, economic and social changes. However, the waters of pension reform were flowing very slowly, almost stagnating in the meanders of a state run system inherited from communist times. In 1998-2002 there were the first signs of increased public awareness of a pension time bomb ticking also in Slovakia, with the first – far from ideal - reform proposals elaborated by the government towards the end of this period. And in 2002-2006 a new "world record" was set as the Slovak pension reform with individually owned retirement accounts was prepared and implemented in just 30 months.

Secondly, throughout the text covering various periods the role of individuals will be constantly underlined. Only dedicated individuals can make the difference. Of course, they also need other conditions working in their favour: a favourable political development, politicians willing and ready to implement the reform, meeting the right people at the right time, interest and positive attitudes of crucial media, etc. The story of the Slovak pension reform is almost a textbook illustration of how all these conditions for success came together.

Finally, these reflections are written also as a tribute to José Piñera for his contribution to the introduction of personal retirement accounts in Slovakia. José is a man who not only pioneered the first comprehensive dissolution of a Bismarckian welfare state in the 20th century. In addition, he is making enormous efforts to spread the important idea of individual liberty by ever expanding the list of countries undergoing pension reform following the example he set up 25 years ago.

II. 1990-1998: The Stone Age of Cosmetic Changes in State Pension System

- **The major Problem of the Period:** The pension "time bomb" is overshadowed by other urgent problems as Slovakia is busy making the transition from a centrally planned economy to a market economy and becoming a newly sovereign country.
- **My strategy:** to conduct research and increase public awareness via lectures and presentations.

The Very First Years of Transition

The collapse of communism in November 1989[1] and the Velvet Revolution opened a window of opportunity for implementation of far-reaching reforms. To understand why a pension reform – the mother of all reforms - was implemented only after 15 years of transition, we need to go back to the beginning of the transition process itself.

1 At that time Slovakia was a part of Czechoslovakia, a compound state – federation of two nations, Slovaks and Czechs, living together since 1918.

In 1989 the Slovak economy had one of the highest shares of state ownership in the economy in the world[2], most of the Slovak exports were directed to non-competitive markets of former communist countries, and the Slovak economy was dominated by several large companies quickly losing their competitiveness, and employing tens of thousands of people. The whole economy and society was in urgent need of fundamental structural adjustments.

As a result, in the beginning of 1990 there were many urgent challenges:

- The transition from a totalitarian Communist regime to a multiparty democracy,
- The transition from a centrally planned economy to a market economy,
- The transition from state paternalism to individual responsibility.

Facing just one of these challenges would be more than enough for one generation. That is why I sometimes call this period "*One Century Compressed Into One Decade"!*[3]. Discussions about privatisation and restructuring of state owned companies, market opening and liberalisation, including deregulation of politically sensitive prices[4] were at the top of the political agenda of that time.

In the late 1980s I was working as a young research assistant at the Institute of Economics of the Slovak Academy of Sciences. It was an exceptionally exciting time as everybody wanted to contribute to the necessary changes. I was no exception. Since free-market thinking was an extremely scarce good at the time, I was looking for the most efficient way to accelerate the transformation towards a free market and a free society.

The first step was to facilitate association of like-minded individuals and that was why – together with my colleague Ivan Svejna – we established The Libertarian Club in the early 1990s. After several months we felt that we needed to take further steps in order to increase our impact. And we invited other market-oriented people[5] to establish an economic think tank called The F. A. Hayek Foundation[6] in 1992. Its main mission was to establish a tradition of free market thinking and free market policies that were virtually absent in Slovakia before November 1989. Later on Ivan Miklos and others went their own way and established their own economic think tank called MESA 10.

In the meantime, history was taking giant steps almost every day. Due to differences in its industrial structures[7] Slovakia was disproportionally hit by the first reform measures[8]. Growing disagreements between Slovaks and Czechs over structural reforms, and the monetary and fiscal policy mix led to the well-known "velvet divorce[3]" of the Czecho-Slovak federation and its split into two internationally recognised states as of January 1, 1993. As a result, in addition to the above-mentioned three parallel historical and unprecedented transitions, Slovakia was forced to face a fourth difficult process: the transition from a federation to an independent state.

The pension system in the shadows

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2 It was about 98 % of GDP.

3 Ján Oravec: "THE TRANSITION OF SLOVAKIA: One Century Compressed Into One Decade", Economic Freedom Network Annual Meeting, Bratislava, October 16, 2003.

4 Gas, electricity, heat, rents, etc.

5 Including Jozef Kucerak, the prime minister of the first reform oriented Slovak government after November 1989, Ivan Miklos, then the minister of privatization in the same government, and many recognized economic journalists, or other well-known people.

6 At that time Hayek was perceived by us as one of the most persuasive symbols of free market thinking of 20th century.

7 dominated by heavy industry.

8 While unemployment rates in the beginning of 90-ies were steadily below 2 % in the Czech Republic, they exceeded 10 % in Slovakia.

Only by recognising all specific features of this period one can understand why pension reform was not a top priority in those days. We were all aware of the importance of the ageing challenge from the very beginning; at the same time we were simply completely consumed and busy debating and solving all other urgent issues associated with privatisation, restructuring, price deregulation, trade liberalisation, etc.

As the years went by and the transition experience accumulated I started to understand that of the above mentioned four historical challenges the transition from state paternalism to individual responsibility is by far the most difficult transition of all. After 40 years of communism people still believed that it is up to the state to take care of them in their retirement, to finance, administer, provide, and safeguard their pension benefits. The institutional framework and the main features of the pension system at the time worked accordingly.

The Slovak welfare state in the first half of the 1990s was still a centralised system taking care of the individual from cradle to grave. It was a compulsory pay-as-you-go system with universal coverage and defined benefits financed from payroll taxes. It was complicated[9], conditions of eligibility were not transparent, benefits were automatic claims, the system was extensive, expensive, and open to abuse. The first changes introduced into the pension system were just reactions to urgent transition problems. For example, as of March 1, 1991 a pension indexation was introduced to protect pensioners against the high inflation rates that resulted from price liberalisation.

However, the original centralised state system did not manage to stay immune to certain reform efforts to decentralise it. It was important that financing of welfare services was separated from the state budget. In 1993 the *National insurance company* was established to take care of sickness, pension and health insurance, and various benefits. In 1994 this institution was transformed into a public tripartite institution[10], and renamed to the *Social insurance company*[11].

Later, in 1996, voluntary and non-universal occupational schemes were introduced as employer-employee schemes managed by pension insurance companies[12] and state were defining the rules of the game and the supervision. There were also other partial changes implemented, for example, preferential treatments of different working categories were abolished as of January 1, 1994

1994 was also an important year because *The World Bank* published its famous report[13] presenting the first comprehensive and global examination of old age income security. This report distinguished for the first time three systems which since have become well-known as the "three pillar" architecture of the reformed pension system:

- a publicly managed system with mandatory participation and the limited goal of reducing poverty among the old
- a privately managed, mandatory savings system
- a voluntary savings system

The report concluded that *"a combination of different income security policies is more effective than any single approach"*.

9 With 80 different kind of benefits.

10 With representatives of the government, trade unions, and employers being present in its board.

11 Taking care of sickness and pension insurance + accident insurance, reduced number of benefits payments.

12 With 100 000 clients minimum requirement.

13 Averting the Old Age Crisis, The World Bank, Washington, 1994.

I read this report, and from the beginning had difficulties accepting its proposals. As for a "freedom fighter" it was impossible for me to accept the idea that the transition from state paternalism to individual responsibility would end up in a semi-paternalistic system where individual freedoms and responsibilities would be limited by obligatory requirements of the government, although I realized that the complete transition would still take a very long time.

Despite my disagreements with major conclusions and the proposed three pillar architecture, the analytical aspects of the report even further increased my interest in these issues. At the time I was giving even more lectures and public speeches focused on the urgency of the pension crisis, the lack of public awareness of these problems, including politicians, policy-makers and major media, and the necessity to take immediate actions to reverse the negative developments. In my papers[14] and presentations I focused on global trends in pension reform and the lack of attention in Slovakia, based on the following foreign inspirations for pension scheme reform strategies: 1. Singapore – a centralised system of mandatory personal savings administered by the state, 2. Chile – a decentralised system of mandatory personal savings managed by private pension funds.

I thought that these inspirations could be applied to the Slovak pension scheme by choosing one of the following reform strategies: 1. introducing mandatory personal savings accounts at the existing Social Insurance Institution[15], or 2. introducing mandatory personal savings accounts and decentralising their administration to either a) existing life insurance companies, or b) newly created specialised institutions (pension funds)[16]. My strong preference went from the very beginning to the Chilean model. Again, I saw a mandatory aspect of these reform scenarios only as an intermediary step towards the system based on voluntary pension savings of individual citizens and with absence of any state paternalism.

In addition to campaigning in Slovakia I was making presentations on these issues abroad, including the following two: on November 12, 1996 I made a presentation of the social security system in Slovakia in Warsaw, Poland at an event organized by the Polish Chamber of Commerce, on December 11, 1997 at a workshop *"Pension Reforms in Eastern Europe"* in Ljubljana, Slovenia I presented a paper called *"Pension Scheme in Slovakia and Relevance of World-Wide Pension Scheme Reform Efforts to Slovakia"*.

III. 1998-2002: Increased Public Awareness, the First Reform Efforts

- **The major problem of the period:** the pension crisis is finally identified as a major problem, pension reform becoming a top priority of the government, however, the wrong solutions elaborated as a result of a leftist politician becoming Labour Minister
- **My strategy:** to fight against approval of the wrong solutions proposed by the Labour Ministry

1998 was a very important year for the acceleration of pension reform efforts as well as for Slovakia overall. From 1993 to 1998 the Slovak governments were implementing mostly bad, mistaken, and irresponsible policies. The originally intended concept of a voucher privatisation was replaced by direct sales of state property to insider buyers[17] with generally negative consequences: non-transparency, corruption, growing collusion between political and business

14 J. Oravec: Analysis of Various Welfare State Systems, Bratislava, 1997, written for The Institute of Liberal Studies Bratislava.

15 "Singapore model"

16 "Chilean model"

17 Mostly by friends, families, loyal people.

elites. Certain sectors and companies were excluded from privatisation[18], politically sensitive prices were not deregulated and companies producing these commodities and services experience serious financial troubles. A restrictive fiscal policy was replaced by an expansionary one[19] with growing budget deficits, and government debt, as government borrowing was crowding out private investment[20]. Since foreign investment was discouraged the Slovak economy was seriously under-capitalised. The legislative framework was increasingly distorted by vested interests[21] Slovakia was excluded from the integration efforts[22] of other transition countries.

As a result of all these measures and their negative results there was almost universal consensus among experts as well as the general public that the country was heading in the wrong direction. The major slogan of the political opposition was embodied into one single word: CHANGE. Even though the 1998 parliamentary elections were won by HZDS, the party chaired by Mr. Meciar, a prime minister with authoritarian tendencies, its coalition potential was close to zero. As a result of this the opposition parties, three right wing parties and one left wing party, were able to form a new government set on reversing the previous bad policies.

Starting in 1998 the government accelerated privatisation and widely used a method of open international tenders. Banking, telecommunications and the energy sector were restructured and privatised by foreign investors. Politically sensitive prices were deregulated and regulatory framework was reformed, more insulated from political influence through the establishment of independent regulatory authorities. Large public infrastructure investments were slowed-down, intentions to reform the public sector declared, and as a result of more responsible fiscal policies government bond rates were significantly reduced. Foreign capital was attracted by (first) tax holiday, and (more importantly) by efforts to improve the business environment. The legislation was also liberalised in many areas and sectors in order to comply with international standards. Finally, the integration efforts were accelerated and Slovakia became a member of the OECD member in December 2000, and had realistic prospects for becoming EU and NATO member.[23]

In the beginning of this period it was clear to our team in the Hayek Foundation that the 1998-2002 period did represent a window of opportunity for implementing many of our ideas, including tax and pension reforms. Since the foundation was established we had consistently been practising our *"think tank-do tank"* approach. We were not only promoting reform ideas and encouraging public debate on various issues, we were always also lobbying for their implementation trying to persuade politicians, policy-makers, law-makers, and opinion-makers that by a contributing to their implementation they would encourage prosperity in our country.

In order to help to accelerate much delayed structural reforms in Slovakia we made a strategic decision back in 1999 that I would accept a position of Chief of Strategy at the Ministry of Economy. I was going there with a vision of the ministry to be changed fundamentally, to make its transition from a ministry conducting old-fashioned industrial, energy, and trade policies based on strong sectoral focus[24], to a modern ministry with modern policies focused on improving the business environment in Slovakia.

18 Including banking, telecom, energy sectors.

19 With public expenditures aimed at large public infrastructure investments.

20 At some point government bonds interest rates exceeded 30 % when there was one digit inflation.

21 Government policies were increasingly favoring some and discriminating against others.

22 EU, NATO, OECD.

23 Slovakia eventually became a member of NATO and the EU in 2004.

24 Picking winners, selecting sectors and companies to be promoted by the government.

Most of my activities were focused on corporate sector reforms that were badly needed to increase the competitiveness of the Slovak economy. It was crystal clear to me that this could not be done without significant improvements of the business environment, especially its legislative, regulatory and administrative framework. In co-operation with FIAS experts[25] my team prepared a strategy paper on the elimination of legislative, regulatory, and administrative barriers for doing business in Slovakia, including a list of detailed proposals and measures how to improve the business environment in a defined period of time. This paper was highly welcomed and appreciated by domestic experts and Slovak as well as foreign businesses as a foundation of pro-business government policies in upcoming months and years.

The tax system is without any doubt one of the most crucial elements of the business environment. The Hayek Foundation started its own campaign for reducing the total tax burden in Slovakia and for implementing a flat tax idea in 1997. In 1997 we established *The Slovak Taxpayers Association* which in the same year launched its very successful project of a calculating and publishing the so-called *Tax Freedom Day*. It increased public awareness of the close connection between high government expenditures and low net wages, including worsened prospects for a prosperous economy. Being in an executive position I brought this fight into the internal structures of the government. In one of the documents elaborated by my team and submitted to government for approval there was an introduction of a flat tax of 19 per cent (still back in 1999!) proposed as one of the potentially most powerful measures to make the business environment more favourable to both domestic and foreign businesses. Since at that time the minister of finance, Mrs. Schmognerova, was a representative of the left wing party, our proposal failed. However, the first seeds were planted, and this venture brought its fruits several years later when the comprehensive flat tax proposal was implemented as of January 1, 2004. In my view this story proves that my life long strategy of deliberately *„setting outside bars"* or *„going beyond what is possible in a given time"* works and sooner or later pays off.

However, I was busy not only by working on laying down the foundations for the corporate sector reforms, a preparation of a restructuring of utilities and their privatisation, or improvements of business environment by eliminating various barriers, and a proposing the flat tax reform. Thanks to my decision to join executive power[26] the Hayek Foundation was able to influence directly also crucial decisions that were important for the pension reform as well: 1. to accelerate and help to approve in the government and parliament the biggest privatization in Slovakia ever[27], 2. to persuade the government to allocate most of the privatisation revenues to financing the fundamental pension reform in future[28], 3. to help combat the wrong pension reform proposals of the Labour Ministry by the government by the end of the 1998-2002 period.

Unlike in other policy areas there were no major changes proposed or debated in the area of the pension reform. And it was not because the problems would not be visible. With a growing number of analyses published it was increasingly clear that fundamental changes were necessary. Contribution rates necessary to keep the 1996 gross average wage/average pension rate were predicted to grow from 27.5 % in 1996 to 48.6 % in 2040. Despite a very low effective pension age[29] there were no efforts to increase it. Even a scenario with a modestly increased pension

25 Advisory agency being a member of the World Bank group.

26 Although my original expectations differed significantly from reality: I expected to complete my mission within a period of 3 months, and finally stayed there for more than 3.5 year.

27 The Slovak Gas Industry, the company transiting a Russian gas from Russia to Western Europe.

28 A significant part of revenues of SKK 130 bln. from selling of a 49 % stake in the company were deposited by the government at central bank with an aim to use it after the introduction of the pension reform to finance an early stage of transition period. These revenues were expected to last for up to six years.

29 59 for men and 54 for women.

age[30] the system would end up in significant deficit by 2040. Calculations showed that if demographic trends were to remain unchanged, in 2040 the receivers of benefits would outnumber the contributors. In other words, each worker would have to pay contributions to cover old-age benefits of more than one pensioner.

Why was there – despite all this persuasive evidence – almost no reaction from the responsible ministry? The answer is simple. Like in the case of the Finance Ministry, the Labour Minister Magvasi represented the left wing party. And he thought that the best way to implement the ideological principles of his party in his area of responsibility would be to pretend that there was still no sense of urgency, no need to change the pension age, no need to change pay-as-you-go financing. As a result, there was no incentive to look for alternative solutions. Even in a case that some solutions were mentioned unofficially, funded - capitalisation - schemes played no or only a minor role in them.

After two wasted years in the second half of 1998-2002, Mr. Magvasi finally prepared his reform proposal. However, it could hardly be called a reform, because what he came up with, if implemented, would be perhaps worse than the status quo. His proposal consisted of creating personal retirement accounts that would not be privately owned, and would be administered centrally by the public Social insurance company, and managed by investment committee members, some of which would be nominated by the government. Simply a nightmare!

When this proposal was submitted for inter-ministerial comments, I put much effort, time, and energy into voicing the strongest possible disagreement of the Ministry of Economy with this particular solution. I remember I called it *"the manifest of collectivism"* during one of our meetings aimed at settling the dispute between the two ministries.

Mr. Magvasi and his party were trying their best to get approval for this proposal from the government. We needed to use a strategy of combination of generating of both internal and external pressure on the minister and his ministry to force them to change their anti-reform attitudes. Even though the minister was using his political backing to defend his positions, he finally surrendered also due to a growing pressure from Ivan Miklos[31] and his team. Fortunately, it was not enough. It was only several months prior to 2002 election when the government decided that this particular proposal would not be even submitted to the government and did leave the decision on the pension reform for a future government.

We have learned our lessons from this dangerous situation of being quite close to an implementation of a perverse pension reform. It was exactly this situation that forced us in the Hayek Foundation to make our next important and strategic decision that brought us further towards increased involvement in the pension reform "crusade": to prepare our own ambitious proposal of the pension reform, and to find potential allies abroad that would help us to fight with ideas efficiently for the reform.

It was in this period of 2000-2001 when I contacted José Piñera for the first time. I did not know him personally. I read about his achievements in Chile and I found his e-mail at his *"International Center for Pension Reform"*[32]. My intention was to get in touch with him and discuss the idea of a potential visit in Slovakia. I remember I expected to hear from him something like this: *I am busy, my diary is full, and anyway I charge a speaking honorarium of*

30 +1 year for men and +3 years for women in period 2002 – 2014.

31 Miklos held in 1998-2002 a position of a Vice-Prime Minister for economic affairs, and enjoyed a strong position within the government being a close ally of the prime minister Dzurinda.

32 Its website is as follows: www.pensionreform.org

XY tens of thousand bucks. Instead he replied immediately: *yes, I can come. My conditions: I do not take any money, when you invite me, I expect you to cover a business class air ticket from Santiago, a nice hotel and several cappuccinos in Bratislava. That is all. Oh no, still one more thing: because there are 200 countries in the world, I would come to Slovakia only in case there would be a realistic prospect that my presence there could help to make the LAST push for the reform.* It was decided. We started to do our homework.

IV. 2002-2006: The New World Record: The Pension Reform Prepared and Implemented in 30 Months

- **The major problem of the period:** After previous periods of efforts aimed at increased awareness, periods of fights against the wrong solutions, the major challenge of 2002-2006 became: 1. a preparation of a sound reform proposal and 2. its implementation.
- **My strategy:** 1. to fill a gap and to come up with our own proposal, 2. to attract attention of politicians by inviting José Piñera, 3. if the reform would receive "a green light", the NFAH team was ready to help with implementation of the reform

We started to work on our own pension reform proposal and on a preparation of José's visit almost immediately. There were regular parliamentary elections called for October 2002. We adjusted all our preparatory works towards this date. We had chosen June 2002 as the most appropriate timing for both the presentation of our own proposal and for the visit of José Piñera. Our team started the necessary analytical works, with Martin Thomay[33] working on the proposal full-time. At the same time an intense communication with José started in order to maximise the results of his presence in Slovakia.

Finally, we came to our mutual agreement that we would prepare a four-day visit of José in Slovakia. The date was set up for June 8-12, 2002. The program of the visit included the Annual lecture of the F. A. Hayek Foundation, the international conference on pension reform organised by the Foundation, presentation of its reform proposal during this conference, presentation of José, his TV appearances, meetings with politicians, etc.

After Jose´s arrival we started his visit with informal dinner in Bratislava Old Town with the Hayek Foundation team. We agreed that before an official part of the program Ivan Svejna would bring him to his hometown Banska Stiavnica, the UNESCO site, to see also other parts of Slovakia than Bratislava.

The next day they together visited Banska Stiavnica, an old mining town and picturesque place about two hours by car from Bratislava. Ivan prepared a small picnic there for the closest friends. Among them there was Ludovit Kanik, a friend of Ivan's, and at the same time a leader of small right wing value based party, the Democratic Party, that was preparing its campaign for the upcoming elections.

During informal discussions José strongly suggested to Ludovit Kanik to put a high priority in its agenda on the pension reform, to campaign with it, and even becoming a Labour Minister after elections with a vision of introduction of personal retirement pension accounts. Even if it seemed to be more like utopia at that time, José's words proved to be almost a self-fulfilling prophecy because Kanik after elections in fact became the Labour Minister and did implement the pension reform…But we still had several months to go.

33 At that time working with The Hayek Foundation, later leaving us with an ambition to establish his own venture.

The next immediate important event for us was the Annual Lecture of the F. A. Hayek Foundation on June 10, 2002. In my opening speech I introduced José as the famous architect of the successful and the best-known pension reform in the world. I underlined that as any important and pioneering reform it has its own supporters and opponents. Most of these debates were available to us. However, it is much better to hear directly once rather than to read ten times the second-hand information. And I gave the floor to José. Since I never had the opportunity to listen to Jose lecturing, his presentation was a big surprise for everybody in the conference hall, including myself!

José in his lecture showed his best performance, making an enthusiastic, eye-opening speech, presenting his famous small pension book, and warning politicians to avoid measures that would hurt pensioners *"do not touch grandmother's money"*. And he was repeating it again and again the next day during the conference, in his interviews with press, in his TV and radio interviews, and during a press conference.

After his return to Santiago I thanked him in my e-mail of June 26, 2002: *I want to thank you for everything what you did in Slovakia to support a pension reform here. From responses of direct participants and from media coverage of your visit it is clear that people here were really deeply impressed by your presentations, interviews, arguments and above all by SIMPLE language you used to talk about these issues.*

I must confess that personally you have surprised even me. Of course, I was looking forward to meeting you as a personality who is well-known all over the world. However, I was expecting to meet someone who is "a former :-) reformer", who is making his living from his past performance. I found that in fact you are the perfect opposite of that. I found a man who is seeing the world as a continuous opportunity to look for improvements of our lives, to identify them, to prepare an action plan and to execute it successfully. And José replied by quoting what Ronald Reagan used to say, *"you ain't seen nothing yet".*

Our conference on pension reform was attended by the specialists and experts from insurance companies, pension funds as well as general public. During this conference we introduced our own proposal of pension reform in Slovakia. Of four types of pension reforms, the parametric changes, notional accounts, multi-pillar models and full privatization of social security, we presented our strong preference for the full privatization. In the long term our proposal would mean an elimination of the current PAYGO system by a system of voluntary savings, without any mandatory aspects. Minimum subsistence level would be guaranteed by arrangements outside the pension system itself.

Again, with my deliberate strategy of "going beyond the possible", we went for this radical proposal as a point of departure, knowing that politicians that were present at the conference were ready to "digest" only certain parts of it. The more radical the original proposal was, the more likely the final compromise would be acceptable also for us.

The October 2002 elections were won by Mr. Meciar and his party again. The situation after the 1998 elections repeated itself also after 2002 elections. Because of a low coalition potential of Mr. Meciar, three right wing parties of the then government coalition were able to form a new government, which was even more reform-oriented than the previous one because it was joined by a newly established right wing party.

A window of opportunity for the second wave of fundamental reforms putting Slovakia ahead of other transition countries was opened after October 2002, including labour market reform, flat tax reform, further reforms of business environment, school system reform, health care reform, fiscal decentralisation reform, and, of course, the pension reform. Ivan Miklos, the deputy prime minister and finance minister of the Slovak Republic in the second government of Mikulas Dzurinda, could report in his article in the Wall Street Journal encouraging news also what concerns the pension reform: "*We are preparing the pension reform to transfer the current pay-as-you-go system to a program of real savings in personal accounts.*"[34]

When this unique window of opportunity for implementation of the ambitious pension reform was opened, we had made another important strategic decision. After my 1999-2002 mission at the Ministry of Economy, we deliberately opted for our think tank to become a do tank again. We decided to send our expert team to help Ludovit Kanik as the responsible minister and his ministry to implement the pension reform we had long been campaigning for. The F. A. Hayek Foundation expert team, including Ivan Svejna, Martin Chren, and Martin Thomay became an important part of the pension reform team at the Ministry of Social Affairs of Slovakia during years 2002 – 2003, with Ivan Svejna becoming a Director General of the Ministry and a Head of the team responsible for a preparation of a reform strategy. Later on, Ivan and Martin wrote a book *"Pension Reform: The Slovak Way"* describing their experience from this period.[35]

Our previous close contacts with the world's best reformers proved to be of crucial importance for the whole reform. It was natural that Ivan Svejna in his new position invited – following a suggestion from José Piñera – two experienced Chilean advisors, Augusto Iglesias, and Klaus Schmidt-Hebel. They joined the team and without their important contribution it is difficult to imagine that the final overall result would have been equally successful.

Overview of Major Reform Features

During 2003 two main legislative acts – the Social Insurance Act and the Old-Age Pension Savings Act – were prepared by the reform team. These two bills have set up the framework for the new pension system that was expected to operate in Slovakia from January 1, 2005. The Social Insurance Act set down changes in the unfunded pension system, the Old-Age Pension Saving Act created a new, fully-funded pillar of the pension system.

The main changes brought by the Social Insurance Act were: a) the new model of calculating of old-age benefits paid by the unfunded pension system using the so-called "Personal Wage Points", b) gradually increasing the retirement age to 62 years, c) a new structure of both mandatory pension contributions and benefits, and d) a complex re-definition of the disability benefits. Based on the Old Age Pension Saving Act, new Pension Companies were able to start their businesses in Slovakia, managing the personal retirement accounts of Slovak workers.

Prior to reform Slovaks were obliged to pay to the PAYGO system contributions of 28.75 % of their gross wages[36], and the system promised in exchange to pay an average old-age benefit amounting to 50 % of gross wages. The reform allowed workers to redirect a significant part of their contributions, 9 % of gross wage[37], to their personal retirement accounts.

The system is mandatory for citizens who entered the labour market for the first time after January 1st, 2005. Citizens who decided that they were not going to retire earlier than after ten years, could opt to stay in the state-operated PAYGO system or switch to the new system within

34 Ivan Miklos: A Flat Tax and More, May 8, 2003 , Wall Street Journal.

35 The book was called "Dôchodková reforma po Slovensky" and was published in Slovak in 2004. It is also available on web pages of The F. A. Hayek Foundation, www.hayek.sk.

36 18 % for old-age benefits, 6 % for disability and survivorship insurance, 4.75 % for Reserve Fund.

37 The single largest share redirected to the system of private retirement accounts in Europe!

a period of 18 months[38]. All citizens who were already retired or wanted to retire earlier than in the next ten years were asked to stay in the state-operated system.

The pension funds, accumulating workers' pension savings, are managed by private Pension Companies. The pension Companies are under strict supervision of the Financial Market Authority. Each of the pension companies set up three different pension funds, each of them having a different portfolio of securities. The Old-age Pension Savings Bill determines strict investment limits for each of the funds, based on type of securities, their issuers and ratings, the main goal being to diversify investment as much as possible to reduce risks.

The battle for private ownership of pension savings in 2003

From the description above one might wrongly assume that everything was almost perfect during the preparatory stage of what finally became a successful pension reform. In reality, just the opposite was true. Firstly, there were growing disagreements over the size and parameters of the PAYGO. These disagreements forced Ivan Svejna and part of his team to depart from the ministry during 2003. Unfortunately, it did not wake up the politicians in charge to the need for adjustments in the PAYGO system and these changes will still need to be made in upcoming years.

There was even more serious source of tension, however. It was a question of ownership of pension savings. An overall situation with two crucial structural reforms, the flat tax and pension reform, looked optimistic, even rosy in the autumn of 2003. In my e-mail to José from November 1, 2003 I was able to report: *Dear José, let me start with great news from Slovakia: last Tuesday our parliament adopted a 19 % flat tax that should be effective from January 1, 2004. In all likelihood January 1, 2004 will also mark the beginning of the pension reform since this parliamentary session is discussing the last piece of the reform proposal.*

Anti-reform forces mobilised themselves in the very last moment and they used a debate on fiscal consequences of private retirement accounts for their own purposes. The EU intervened into our reform efforts when Brussels announced that increased transition costs will not be tolerated and will be considered as a regular part of the deficit. This was a "cold shower" for some reformers and also anti-reformers started to come up with the proposals how to meet a Maastricht criteria by keeping all financial flows of the reformed pension system within the public finances. In other words, how to have pension savings accumulated in personal accounts of citizens owned publically instead of privately.

This was one of the most important issues, because without private ownership the whole reform would be only mimicking the true reform. Fortunately, in the middle of the parliamentary debate on this issue, a visit of our parliamentary delegation to Chile was scheduled for this period. The members of our parliament visited Santiago where they held many meetings with people associated with the reformed pension system in Chile, including a special 3-hour meeting with José Piñera.

What happened during that meeting is summarised in the following e-mail received from José on December 9, 2003: *"Jan, Slovakia should approve a pension reform in which every worker OWNS his/her retirement account. I cannot support a reform in which the government owns the accounts, because there is a clear possibility that some government will in the future confiscate all or part of the workers hard-earned money. It will be another big frustration for the Slovak*

38 January 1, 2005 and June 30, 2006.

people. I was very surprised to discover this key departure from the Chilean system only once the delegation was here. Nobody had told me about that. Since I am committed to principles, and not political tactics, I oppose that distortion of the idea of private personal retirement accounts and I said that with full force and independence to Minister Kanik and the full commission (and all the deputies supported my position). Best, José"

The further acceleration of the next course of events can be clearly seen in my reply to José from December 11, 2003: "*Dear José, you have made a great impression on all members our parliamentary delegation. After their return from Chile they were repeatedly making references to views of yours - as views of an already well known "classic" in Slovakia. I wish we could send there all our MPs, and all ministry staff, including the minister, well before they started to work on the reform..."*

In following days, after many exciting debates and negotiations in a parliament, there was a right decision taken be our deputies. Minister Kanik could send his letter to José Piñera on December 19, 2003 starting in a following way: "*Dear Mr. Piñera, I would like to share some good news with you. On Tuesday the 16th December 2003, the Slovak parliament approved the law on the old-age pension savings scheme. Thus, as of 1 January 2005, Slovak workers will start depositing 9 % into their personal savings accounts. These savings will be their private property, to which succession rights will fully apply."* And he continued: "*Your visit to Slovakia had started an intense discussion about the pension reform, and enormously influenced the generation of a favourable political climate. I am confident that the pension reform, borne by your inspiration and with your significant assistance, will bring not only higher pension to our citizens, but also freedom and self-assurance while seeking out the correct way. The time of our visit to Chile coincided with the period of acute search for parliamentary support of the main law of the reform. The discussion with you made great impression, and contributed to a major extent to the determination and will of the members of our parliament to push through this historically new project of the pension system in our society. Ludovit Kanik"*

The same day, December 19, 2003, José Piñera replied to Kanik by e-mail: "*You have given me the best possible Christmas gift. Congratulations for a pension reform that, as you say, gives private ownership of their pension accounts to Slovak workers. ...I have already begun to tell my network around the world that Slovakia, with its twin structural reforms (pension and flat tax), has become a leading reform country in Europe".*

All in all, when we consider June 2002 as a sort of a "kick off" event of the true reform, there was a relatively very short period of 30 months within which the reform was successfully debated, prepared, and finally implemented. In other words, a new world record in the discipline of pension reform implementation had been set.

The second visit of José Piñera **and the June 2006 parliamentary elections**

On June 17, 2006 there were parliamentary elections in Slovakia again. Pre-election public opinion polls were dominated by a leftist populist opposition party SMER with ratings close to 30 %. There were two major issues in their pre-election campaign: 1. heavy criticism of all reforms[39] adopted by the right-wing government, 2. promises of reversal of most of these reforms under a slogan of a reinstallation of a welfare state that is typical for continental Western Europe. Even the pension reform was demonised as a mere business for the private pension funds at the expense of pensioners.

39 Described as irresponsible and even "brutal" social experiments on citizens.

At the Hayek Foundation we envisaged an escalation of these debates in our pre-election campaign well in advance. That is why we made a preliminary agreement with José on his second trip to Slovakia still back in 2005. We thought it was a good timing to invite José in May 2006 in order to defend the pension reform and its major results.

When it came to the program of the visit, we agreed that we would basically follow the pattern of his first trip: 4 days, the conference on the pension reform, and many press, TV, and radio interviews and press conferences, including the major press conference with the minister of finance, Ivan Miklos. During this press conference Ivan Miklos announced that the pension reform was one of the most fundamental reform measures of the outgoing government that was already benefiting millions of workers, accumulating SKK billions of pension savings on their private accounts. In his presentation José Piñera congratulated the outgoing government and the minister for a well-done job while implementing the reform and underlined the importance of the reform for the future prosperity of Slovak citizens and their economy.

In his keynote speech in the opening session of the conference, assessing the first results and prospects of the pension reform, José summarised the major contributions of personal retirement accounts in improving the performance of the Slovak economy, and above all, for increased standards of living and individual freedoms of the Slovak citizens in the future. And he kept sending the same major message while making many follow-up interviews with both printed and electronic media.

In addition to media, politicians and political parties were among our target groups when organising this conference. That is why there was also a panel discussion with representatives of political parties to express their views on the pension reform, and to reveal their plans as far as a future of the reformed pension system concerned. 6 of 7 relevant parties likely to make it into the parliament stated clearly that they were satisfied with the pension reform as implemented and that they had no plans for significant changes. Only the 7th party, SMER, remained a risk factor, as it considered reducing payments to IRAs from 9 to 6 percent, or other significant adjustments[40] in the reformed pension system.

Even though SMER finally won the elections on 17 June 2006 with a comfortable 29 percent, three right wing parties of the outgoing government coalition got 38.5 percent, including the leading party of a Prime Minister Dzurinda with surprising 18.4 percent. Total results - 29 percent for the left, 38.5 percent for the right, and 20 percent for the centre[41] - were not bad at all. All in all, the right wing parties were even in a position to stay in power if they made an agreement with Mr. Meciar who changed his behaviour and strategy significantly during the last four years[42]. However, it was still not enough for the Christian Democrats and they announced they would never form a coalition with Meciar, so this option was not explored.

The trick was that there were two other parties mentioned above with their total 20 percent. The new government was thus formed as a combination of the leftist opposition party SMER, led by Mr. Robert Fico, and two other opposition parties with Mr. Fico as the new prime minister.

Despite these developments I remained confident that we would be able to keep the majority of the reforms unchanged, namely the flat tax and the pension reform. To achieve this, we needed to invest almost all our time and energy after the June 2006 elections into lobbying and defending

40 Even to abolish the whole reformed system.

41 For two parties - The Slovak National Party and HZDS, Mr. Meciar´s, the former Prime Minister (before1998) party – declining to define themselves as neither left-wing nor right-wing party..

42 In a positive way.

crucial reform achievements, including the pension reform. We used a strategy of a public campaign called *"Save the Pensions"* that was combined with internal lobbying via employers´ organisations and other pressure groups.

There was no guarantee that our voice would be heard[43], but mutual communication was still better than no communication at all. SMER as the strongest party of the new government coalition used its right to nominate ministers with heavy portfolios, including the ministry of labour and finance. Their statements after elections were significantly less radical as compared to their pre-election rethorics. The new lady minister never repeated the pre-election fantasies about abolishing the reformed pension system. And with more and more days in the office she was closer and closer to keeping the 9 percent of contributions than proposing a reduction. The only firm commitment that remained in terms of the reformed pension system was to make it voluntary in future.

On 1 August 2006 the new Prime Minister presented his government declaration in parliament. When dealing with the pension system, much attention was paid to ways to improve the stability of the PAYGO system. On the reformed pension system, the new government declared: *"the government will maintain the system of old-age pension savings system"*. No single word on its abolishment, no single word on any potential plans to reduce the contribution rates. The only fundamental adjustment the government finally declared was its plan to make the reformed system voluntary. Although future consequences of this measure need to be analysed more in-depth, after more details of these plans will be released, of all measures that were considered by the government, this is the least dangerous. Its flaws can be eliminated by improving the pension funds' marketing strategies when competing for future clients within the PAYGO system. Of course, a *conditio sine qua non* of this optimism is that the government does not make the PAYGO an artificially attractive alternative for workers considering their personal options.

At the very end of each story we usually want to a Happy End. As we know *"all is well that ends well"*. Can this be considered as the Happy End of our Story? I do believe it can. Firstly, the new leftist government decided to keep the reformed pension system. Secondly, the figures say it all: a total number of people switching to IRAs is about 1.4 million, i.e. about 70 per cent of all eligible people, with SKK 17.5 billion accumulated pension savings in their privately owned savings accounts.

V. Concluding Remarks

I know from my practical experience that in order to succeed in implementing fundamental changes, several factors need to be in place: 1. open crisis – and in Slovakia we had it after 1993-1998 period of irresponsible macroeconomic policies, and the lack of microeconomic adjustments, 2. appropriate inspiration and a reform model – and we had them in José Piñera , and his reform efforts in Chile, 3. a free market think tank and "do tank" – we had the F. A. Hayek Foundation, 4. politicians ready and willing to implement the necessary reform steps – we had Ivan Miklos, and Ludovit Kanik.

Even if all four factors would be in place at the same time, it still does not need to be sufficient. There is still another factor that needs to work in favour of reform efforts. The framework conditions need to be supportive as well. If minister Magvasi had been able to get approval for

43 There were also trade unions and other groups lobbying and having quite opposite priorities.

his bad reform proposal, there would be no true pension reform based on private savings. If the two leaders of the Slovak National Party had not started quarrelling before 2002 election and would not split the party, Mikulas Dzurinda would not have been able to form his second government. If the parliamentary delegation´s trip to Chile had not coincided with the debate on ownership of pension savings the most likely outcome would have been a very different pension reform. Consequence: if also the framework conditions had not worked in favour of reform forces, there would be have been no pension reform as it was finally adopted.

Once again, all of these factors – open crisis as a starting point, appropriate inspiration and reform model, a small group of dedicated free marketers, and politicians able and capable to implement necessary reform steps, and generally favourable framework conditions - needed to be in place in order to make radical reforms in Slovakia possible, including the pension reform. I am sure the same can be done in every single country in the world that is still on José's list of non-reforming countries. And hopefully, after a reading of this Story someone from one or more of these countries will get inspired and will start to make the first small steps on the same reform path as we did many years ago in Slovakia.

Bratislava, September 1, 2006