Is the idea of social system fading away?

Interview concerned social security
Published in June 2010

Dušan LUKÁŠIK acted as the head of analytical work on the Pillar II pension reform in 1999 - 2002 and as an advisor to the Ministry of Labour, Social Affairs and Family of the Slovak Republic. His opinion that changes to details can destroy good systems will be explained in detail during an interview, by Anna Komová.

Is the idea of social system fading away?

The issue of the social system in Slovakia has become a current topic for discussion again. The deficit of the Social Insurance Agency has substantially increased, social systems, together with public money need solutions. The question remains, what is the best solution for Slovakia.

Very often the issue of social system includes solutions that simplify the problem into black and white views, and are often subject to objectives of a particular governing party. Unreasonable money paid out on commissions in 2004 - 2005 amounting to billions of Slovak crowns implies the misuse of political decisions for the benefit of individual interest. Throughout the period of eight years one could hear opinions that the Pay-as you-go insurance system needs to be eliminated and the capital fund increased, while on the other hand, it was said three years ago that the labour revenue was higher than the revenue from the capital fund, therefore the capital fund functioning needs to be stopped, or at least restricted. As usual, extreme solutions are not the suitable ones and provide just a restricted view of the problem, while in the case of the social system, it appears its purpose and implementation seem to be fading away. The main task of social system is to solve social risk of a citizen and his family. The social risk and its categories are precisely defined by the law. The reason why social system is so complex relates to the fact that the complex system of social relations interacts with comparably complex economic system of the Slovak Republic, being connected with economic environment in the rest of the world. These systems dynamically interact whilst at the same time the economy system itself is dynamically evolving. To grasp complexity of such development requires both abstract thinking, in order to define essential parameters of such system, and prognostic analysis methods. Moreover, with modern instruments of capital market and risk management, the complexity is yet to become greater.

There has long been a debate in media on "profitability of first or second pillar". What is your opinion on this issue?

This question was ridiculously raised by media. The initial solution for social system was to fund social risk continuously in so called Pay-as you-go system, including pension, disability or widow's pension and other social risks related to loss of income. The aim of the initial system was to economically finance such social risks so that the society has lowest possible expenditure in order to fulfil the given criteria for benefits coverage. This shall minimize expenditures as a whole, while maintaining basic standard of living of citizens who are facing social risks. The issue of social system needs to be solved in such a way as to motivate an individual - a citizen by suitable means, to prevent misuse by citizens and, at the same time ensuring fulfilment of its purpose. The idea of social system is not to provide luxury, but ensure a dignified living for everyone who is experiencing a particular risk, being classified as a social risk. The way the issue of social system suitability or non-suitability has been discussed in debates in Medias; there were two different groups of proponents. We can say that arguments that the public heard from them had no value at all, moreover, that they had no relevant sense as to the social system solution whatsoever. These arguments were based on accounting principles, with politicians counting votes they would receive at the end, and not how to solve the problem of sustainable social system throughout dynamic demography changes and economy development. The reason is that solving the social system must be based on activating the inner strengths of the social system in order to influence positively formation of the labour market and to promote establishing and sustaining the three-generation family. The importance of social system to anyone is that he encounters it before birth, through his life, and even after death.

Let's go back to the social system solutions. What is the basic purpose for the Pillar I and II being solved?

The basic purpose for the Pillar I and II being solved lies in several essential facts. First of all, a good solution harmonizes motivation of an individual and required level of social solidarity. This comprises of a merit principle and principle of a redistribution which expresses social solidarity between individual income groups. An ordinary traditional social system, having been proved by years and functioning in many countries, is based on contributions derived from a minimum wage up to the three times of that wage on the part of income. On the part of expenditure it is important to ensure a minimum pension of 1.2 times of the minimum wage for people with lowest income. Unless redistributing resources, the contribution from minimum wages fails to ensure this. In essence, there are two solutions only. If we maintain the merit principle on the part of pension and we shall continue to pay out pensions at 1:3 ratio, as it is in case of contributions, then the social system fund needs to be raised by general tax. The result would bring higher costs of labour and lower competitiveness of our economy. Such was the solution introduced by the second Mikuláš Dzurinda government. The Pillar II based on individual savings means more expensive social system and strengthening merits in the Pillar I means greater pressure on economic sources. The result is that the financial sources of the social system are running out, hidden and without being noticed by a common citizen. After a couple of years the social system deficit will be visible, as it was in 2009, even though experts were aware of it at the time of its implementation. A solution to increase contributions 4 times the minimum wage has two effects: it increases a part of labour costs and a part of a labour with higher income will become demotivated, under the misinterpretation of money being channelled into the system by a citizen. Moreover, such raised problems are impossible to solve this way economically, as evidenced by facts of 2009.

How can the social system deficit be solved?

First of all we have to clearly state that the mandatory contributions into the social system are imposed by the constitution and thus restrict the employers in how to handle their assets, as they are obliged to pay contributions and tax if they want to employ a worker. Basically, for an employer it makes no difference whether it is a contribution from employee's gross wage or a mandatory tax from an accounting point, in both cases it represents an expenditure for the employer. The employer is obliged to comply with these conditions under the threat of property distraint. In this context, the money paid in the form of mandatory contributions imposed by a state, is always public money. What happened at implementing the Pillar II was that the public money, used in social security system, was suddenly divided and it was said, in contradiction to any logic, that it was private money that is to be channelled into private accounts and shall be the subject to inheritance, even though the money is the contribution of which is imposed by law and enforced by coercive measures. This step substantially increased expenditure on social system. The social system is drawn without being noticed, while the solution of 2004 was introduced without the information about future increases in taxes and contributions in advance, so that the shortfall in the social system would be covered. The next significant moment was when the second government of Mikuláš Dzurinda increased the benefit from the insurance social system above the community agreement, which is valid through the active life of a citizen. It was popularly called the merit increase. The social system thus faced a significant problem, because citizen had been working for it, for instance, 40 years under the community agreement on redistribution principles 3:1 on entry in form of contributions, with solidarity redistribution 2:1, and all of a sudden, the social system is being changed on part of expenditure to almost 3:1 ratio. A person shall attain such right when he retires, yet for the period of 40 years when he participates at creating financial resources through the employer's payments, he or she was creating them on part of expenditure under the 2:1 ratio. It is the problem of increased expenditures and the problem of a constitution principle on attaining the rights. For the period of two years since its establishment, the Pillar II has been transformed from initial saving system for pension into a hybrid of saving and insurance system. If the most suitable for a community is the cheapest system, then the Pillar II is undoubtedly the best solution from the economic point of view, being based on insurance principles, the same applies for the insurance system, with redistribution mechanisms from 3:1 to 2:1 ratio. This is one of the most fundamental aspects of a solution that would cut the social system expenditure, yet keep its purpose. An individual account enables to accurately express the merit of an individual under the balanced solidarity, that can be easily checked by an individual. Furthermore, the distribution of risk between the labour revenue and the fund revenue as a source of the pension shall remain as well as insurance principles with applicable degree of solidarity for other social insurance benefits.

There are discussions in the political circles on postponing the retirement age to 65. Is such solution necessary?

We conducted these calculations in period 1999 and 2000. Various social economic models proved that the average age of Slovak population has increased by eight years, in contradiction to the initial conditions of the social system, coming to conclusion that it is crucial to find solutions to financially cover longer life expectancy. Various analyses have proved that Slovak women live eight years longer than men, and women with children live statistically longer than those without. These are facts. However, is it possible, yet correct, to increase retirement age by administrative means without having to consider current health of a citizen. Should it be assessed again by a civil servant? How much grievance will it cause? It is obvious that the free decision made by a citizen needs to be strengthened. It is him who knows best his economic situation, health and motivations. It's been evidenced that to shift such competence to a citizen is far better solution, so that he himself can freely evaluate his situation and objectives, once having fulfilled criteria imposed by the law. Discussion on suitability or non-suitability of the Pillar II included also issues whether to have 10 or 15 years-limit for contributing into the Pillar II. Such question from system solution point of view makes no sense. The only important thing here, as for the social system, is the period of mandatory contributions into the social system, and thus accumulating resources in the social system. It does not really matter whether it is the first or the second pillar. It seems that the minimum is 35 years provided that if the average age increases so does this condition. Once this condition has been met, the Pillar I and II must be tested whether accumulated sources are equal or more to 1.2 times the minimum wage calculated to cover mean life expectancy for the given age. Once this condition has been met, a citizen can decide whether to continue to work or not or whether to continue to work and contribute money in his or her account. This allows creating approximately 10-year interval between 55 to 65 years when it is up to people to assess their then current health and financial conditions, and they themselves shall decide on when and how to retire. Upon reaching the age of 65, a citizen shall be assessed whether there is a sufficient amount of money in his or her account, or whether they shall be entitled to claim a benefit from the social system or social support system. It is quite right to agree with the opinion that the administrative shift of the retirement age to 65 needs to be turned down. The above mentioned solution represents a very elegant way how to approach the people and concern their needs and merits when building up resources of the social system, and of their own, too. Please, take note, that 35-year period of active contributions into the social system does not include the period of a person being unemployed. A citizen must try hard to preserve a job through continuous education and qualification in order to remain attractive in the labour market. An individual account simply requires the people to be active on their own.

There has been criticism related to changes of contributions into the Pension Fund Companies and criteria how to evaluate efficiency of such funds. Can we say that the reason for people losing 20 to 40 % growth in the stock market is due to amendments to the legislation?

Such opinions were published according to retrospective calculations of shares revenue conducted by authors of such opinions, saying that if we had invested into the shares we would have made profit of the above mentioned value. The authors of such analysis assume that they can anticipate the price for shares when going up. I have just two comments to these bizarre analyses. When the second pillar was introduced, the entities had to include in their promotional materials information that the revenues of the past are not guarantee of the revenues of the future. Those who carefully monitor principles of capital market know that the probability of being able to forecast that shares will go up or down is 4 per cent. Thus there is 96 per cent probability of wrong anticipation. These are facts based on specialist literature. All of these "visionaries" are like the wise generals after the lost war. The core of problem that brought the changes to legislation is the change of risk. While before the changes had been made in legislation it was a citizen who bears all the risk connected with investment, now the Pension Fund Companies are bearing the most part of the risk. But, if it is the Pension Fund Company making decision on investments, why is the citizen being held responsible when he has no influence over it whatsoever? Moreover, a person, making mandatory contributions into the Pillar II each month, is not a voluntary contributor who can stop the payments whenever he wants to. His contributions continuously flow to the account. The crisis of 2008 on financial markets clearly proved that private sector cannot secure even private financial sources, nor it can secure the public money. As in the USA, the EU countries are those who redeemed from public money private banks and financial institutions, or participate in order to redeem the country debt via higher tax payments. When the banks show profits, the revenue is distributed into the private sector in the form of sky high benefits for managers and dividends for shareholders and when the banks are in trouble, the people's taxes cover the loss. Basically the same problem is with Greece. Misconduct of Greek civil servants, incapability of Euro officials and Commissioner, together with rating agencies and bad risk management in private banks resulted in that all Eurozone citizens have to pay through public resources in order to solve this problem. Once again it is the Eurozone public sector repaying insurance to private bank through Greek accounts. Criteria of Eurozone fail to be met and even if we can see some efforts to find the best possible solution to this problem, the pressure from people shall reach such grade that the truth will have to be told and offenders will have to be held responsible. Not just from political point of view. Another scenario is that financiers having received public money which saved their banks shall continue to drink to the Eurozone tax payers at the most expensive Hotel Paris in Monte Carlo, what actually did happen, or they will organise one week party in California as experienced in

USA. Here lies also the problem of the Pillar II. First of all, the Pillar II transforms the hidden deficit to be economically expressed and recorded in the financial books. Since many Eurozone countries have only the Pay–as-you-go insurance scheme, the deficit is not recorded in the books, even if it often comes up to 3% GDP. At the same time, the Pillar II assets should be secured against inflation. Because a person, on behalf of whom an employer has been contributing, after 40 years does have the right to receive at least the same value in return when claiming a retirement benefit. This security must be implemented by an administrator of accounts. However, the private sector cannot secure the scope of real public resources that the Pillar II has and will have (around 1 GNP). It simply has no instruments to do it. But the state does. The AIG, the biggest financial institution in the world, went into serious financial troubles near bankruptcy and would have been dissolved with all its fatal consequences of domino effect had there not been hundreds of billions of US dollars provided from the USA state budget. I am therefore not surprised that Pension Fund Companies are not willing to insure assets against inflation, since it proves to be a serious system problem. On the other hand, the insurance based not only on inflation rate but also on wages increases as being the case in the Social Insurance Agency means nothing but increase in expenditure and has no real justification, apart from lobbying the social partner. Try to imagine going to a bank. If you want to borrow money you must prove your solvency, you even need to possess a property to secure the loan. In addition, you have to pay interest, composing of two elements; first one evaluates money up to the rate of inflation and the second part is profit of the bank. That's how a common bank treats people. In case of the Pillar II, the state established a bank where employers pay mandatory contributions (for employees - citizens) imposed by the government as part of the condition under which it is possible to employ people. The Pension Fund Companies borrow money from these accounts claiming that they bring higher value to the money. And they do take charges for this. Indisputably, they should pay back money including the inflation rate (only then they return what had been borrowed) and charges should be derived from the share of the profit. Moreover, they should be able to issue assets guarantee to the level of the inflation rate. Wages increase appreciation represents an unreasonable requirement. As you can see, even a complex problem can be simple, when put clearly. Concerning your question, the Pension Fund Companies were free to invest, especially when the stock market bottomed out, as it was in 2008 and at the beginning of 2009. In the second half of 2008 the top investors in the world sold bonds and closed financial positions (except what was necessary to hold liquidity positions) and invested in stocks in order to protect their money for next 10 to 15 years against inflation, which had been expected in one or two years' time, and should last several years. Our Pension Fund Companies did exact opposite. They sold stocks and created bond and financial positions. Only time will tell whether it's been the right strategy or not. However, it's been a free decision made by managers of the Pension Fund Companies, thus the responsibility shall rest with them, be it good or bad. It's ridiculous to assume that to sell stock was due to a change of legislation. It's worth noting that if it is Germany or France facing a dilemma of whether to save banks with poor risk management or to indebt public fund system, they opt for indebting the public fund system, currently being the Eurozone. This is also connected with the problem of newly issued money. To withdraw it from circulation means potential loss of the bank sector liquidity. Who shall bear responsibility for possible collapse of banking system that had just been saved? We can learn from the past that such dilemma has always been solved by inflation. The problem of Greece having been solved by another wave of public sector loans simply proves the thesis of applying the long-term solution to the increased monetary base by inflation. Many investors observe such risks more clearly than ever before. Particularly in the USA they do.

Let's go back to the social system reform, concerning demographic developments. What does your experience of the past imply?

Our models of 1999 up to 2000 have clearly shown that unless the situation has been solved, the social system shall create a deficit in public finances of around 2 % GDP. It's the system characteristics of an insurance social system in combination with demographic development. It's been evidenced that dividing system into the Pillar I and II, with 9 per cent channelled into the Pillar II, enhances transforming the social system in a 35 year-long period, where the first 10 years are critical (as) to the stability of the social system. In essence, we should be grateful to the madam minister of labour, social affairs and family for her efforts conducted to stabilize the Pillar II system, even though some significant changes have not yet been implemented. On the other hand, our solutions included arguments that it is complete nonsense to make one generation carry all the burden of economic transformation alone. To transform the social system we have proposed special type of bonds issued by the state, which would be due in 75-year term with interest equal to the rate of inflation plus 1 per cent. This deficit of social system, currently hidden, is possible to be paid off in 75-year term. The problem here lies in the fact that in case of Pay-as-you-go system the deficit is not yet recorded in the books, even though the deficit has been accruing. I am sure, that the situation in Greece shall finally raise this issue and it will be obvious that this problem concerns many countries in the EU. The fact that we don't record it in the books does not mean that it's not there! That's why the debate about the imbalance between the Pillar I and II causes nothing else but problem which gradually uncovers and gets covered again, and gets passed on future generations. The already solved problems shall come back again. Unless we set up an intergeneration solidarity structural fund from the state assets and bonds meant for the pension reform only, we may have problems to find sustainable solutions to the social system. It's also a matter of whether the public money meant for the social system is the money to operate within the free capital circulation, as required by the EU. Slovakia currently offers financial stimuli from the public resources amounting to 15 per cent for foreign private capital. At the same time II. Pillar sends abroad free of charge own public capital. From economic point, this is a complete nonsense that significantly damages public money and financial position of Slovakia as a whole. The current way of solving the social system is unsatisfactory, yet possible to be transformed, upon system adjustments, in order to create positive stimulus and significantly shape the labour market through individual accounts. Such solution will support the creation of family and help them to sustain it under the three-generation model. The social system, however, fails to provide this, or provides it to a limited extend.

Can you clarify the idea of active formation of the labour market and family?

The idea is based on the fact that what is anonymous, without any direct connection with people is later misused or causes demotivation. Generous social systems made people consider children only from an emotional point, not an economic one. The emotional point is very often already met with the first child. It causes demographic problem in many countries, largely in those where the pension scheme provides 50 per cent and more in the form of retirement benefits. It is not the own child, yet the anonymous sack of money provided by a country that ensures the pension. It's been evidenced that this is the key to demography problem. Under such generous security social system a child is not needed anymore, the child that would take care of parents as it expressed in Three Coins fairy-tale. Instead, all of us anonymously shall put the money together. We all just have to work and pay contributions. The child is not needed anymore to secure pension. It is the same with the system of unemployment. We all put money together in one fund, with only a proportion receiving them back. Once again, there is anonymous relation between payments and a claimant. Unfortunately, there is a whole range of cases of people refusing to work, for less money, preferring to claim benefits instead. Not even mentioning motivation towards the lifelong education to stay attractive in the labour market. As soon as there is an individual account we can solve the social system by dividing the risk, connected with unemployment, into an anonymous common fund and individual account of a person. Thus, if a person is acknowledged that a part of unemployment benefit is paid from his or her individual account, he or she shall think twice as whether to "eat up" their retirement benefit. Moreover, the incentive to broaden education and working habits shall be enhanced. It is very similar with creating the three-generation family economic ties. If we channel a part of a person income tax of a child, after it entered employment, into the account of his or her father or mother, then parents will be motivated economically to have a child at an earlier age and they will invest into a child's education, influencing in this way the amount of income tax that would be channelled into their accounts in the form of retirement contribution and hence benefit. To have a child, or more children, won't be enough, the children will have to work, and with better education they will have higher salaries. This, of course will influence the type of education chosen towards the one that ensures real opportunities for employment in the labour market - in other words, subjects having no real value in the labour market will naturally disappear. With the economic view, the parents will be naturally motivated to have children and invest into their education providing for them real opportunities in the labour market. In this way, as it was in the past, we shall create three-generation families, applying economy proved by generations as written in the Three Coins fairy tale.

You have been engaged with the social system for a long time. When did you actually realise the need to solve it?

We invested in the Gescia company in 1994, concerned with the Pillar III, the supplementary pension scheme. We were interested in middle and long-term investment sources. I started to be concerned with the social system reform itself in 1999. First solutions were proposed at the beginning of 2000, lying basis for the idea of dividing the social system into the Pillar I and II. The process of solving has been subject to many adjustments and long-term tests were necessary. In 2001 it was obvious that the issue requires a major public discussion. Upon reaching an agreement with former minister Magvaši, we distributed material to all concerned to start discussions. It was interesting to observe a whole range of those who want to solve this issue. A whole range of solutions to the social system has been presented. For me it seemed like a great laboratory where ideas and principles are being tested and evaluated carefully. It's more efficient to analyse coming ideas and solutions and to slowly build a social system that would be consistent. I did not dream in 2000 that someone would be driven by greed so greatly and would make people believe that the individual account turning into saving account is positive thing and the insurance principle, with redistribution allowing to fully cover social risks defined by legislation, would be dropped. Furthermore, that people would be deprived of making free choice, violating the equality of opportunities with further impact on their rights as to the amount of retirement benefit claimed. As I have already mentioned, it is the matter of 35-year period, where efficient solution requires at least three generations bearing the economy burden. That's why we have to approach the process with patience, caution and great deal of arguments. Otherwise, if we make mistakes it might be costly in the future to eliminate them. Not many public finance areas are as complicated as the social system is. The social system represents a half of the public finances. Even an elephant can be eaten when consumed in small pieces. That's why the social system should be the topic for public discussions, we should return back to its main purpose and step by step analyse various possibilities and solutions. It's an issue requiring around six years of methodical work, applying solutions proven by the past in order to create integrated system for the benefit of a single person, family and society. Unless a nationwide agreement can be reached, this issue is practically unsolvable, as evidenced by the current situation.