Minister Andrej Bajuk

Opening statement

International Forum on Pension Reform: Exploring the link to Labor and Financial Market Reforms

Welcome all to this important International Forum on Pension Reform. While a lot of progress has been made on understanding the fiscal implications of population aging and we are now clearly aware of its consequences, less still has been done in other important and related areas. That is why it is so relevant to devote this Forum to explore the links between pension, labor and financial market reforms. We are glad to have international leading experts and practitioners which will enrich our understanding of the issue as well as to update us on the state of play and progress made in these three interrelated areas in our countries and international level.

Consistent reform in the pension systems, labor and financial markets can generate important positive synergies. Pension system embed incentives that affect the labor supply of older workers, while a high level of employment also ensures high levels of contributions into the system, higher growth and returns. Similarly, diversifying the source of retirement income and its risks can facilitate the development of financial system, with positive effect on labor demand and supply and economic growth. Thus, this Forum can shed light on the complementarity of reforms in these three areas and on how to ensure consistency among them.

Without doubt the challenge of aging is monumental and addressing it requires sustained effort and continuous policy fine-tuning. Pension reform might be best described as a continuous policy endeavor. The international experienced of countries that embarked earlier in addressing the challenge or have well developed financial markets and pension products indicate that design of pension system is an ongoing task. This is the case for example of the recent changes in the pension systems of UK and Chile. We can learn a lot from each other and use this experience to address our country specific circumstances.

The common challenge of aging of population does not only point out to future reduction of employment and growth, financial returns and pensions, but what might be characteristic of the European set up is that in the future labor markets will become more integrated and more flexible forms of employment rather than permanent ones will become more dominant. As a result labor markets will become more flexible and coverage of pension will turn to be even more challenging for all. Similarly failures or successes in reforming pension systems in an environment of more integrated labor market where labor supply will shrink might become important driver for labor mobility thus further reinforcing or hindering pension provision. Such a dimension will have to be incorporated in the design and modernization of pension systems and consistency between labor market reform and pension coverage ensured.

Probably we would agree that the final outcome of pension reform seen from different backgrounds will be that of ensuring adequacy of income at retirement for the remaining life of individuals. Such an endeavor requires a system design that minimizes the risks of delivering the objective. From the fiscal point of view this will include long-term sustainability of public finances (affordability) and eliminating contingent liabilities from wrong system design; from the labor market perspective the system should encourage labor participation (robustness); from the financial market point of view policies to foster its efficiency and soundness in providing and managing products related to accumulation and de-accumulation phases and; from the social point of adequate provision of risk sharing and distribution.

Undoubtedly at the core of ensuring adequacy of income after retirement to cope with the demographic environment is the adjustment of pay-as-you-go benefits towards affordable replacement rates. Equally important is to offset such adjustment by strengthening incentives for labor market participation and saving. In particular, this can be done by providing incentives to work longer and increasing the employability of old workers and improving the efficiency and soundness of capital markets. But what is key to reforms in the tree areas is that they should be perceived as part of an integrated strategy aimed at delivering adequate retirement income.

The agenda of the Forum around the three key topics provides a unique opportunity to look at the interrelated dimension from a reform perspective that supports its complementarities and synergies.

The first session can provide insight on strategies towards rebalancing of replacement rates towards affordable and adequate levels. We can exchange views about intergenerational burden sharing in shaping the reforms: how much burden can shoulder current and future pensioners. We can explore how to ensure a fair transition to a mixed system of income retirement provision. The focus can be on the obligations and risks the public pension schemes can take, play and afford. In this regard distinction can be made as to the provision of social insurance and welfare assistance.

Secondly, we can discuss the role that incentives to work longer and underlying strategies can play in offsetting the reduction in replacement rates due to increases in life expectancy: how to extend work and how long we can afford. Similarly important is the role that diversification and broadening the sources of retirement income can play in addressing the decrease in replacement rates due to the drop in fertility. In this regard the key issues when shifting the risk from government to households are coverage and proper design of funded schemes. In particular, how to ensure coverage of funded pensions and how to deal with institutional design features of funded schemes to underpinning adequate provision of replacement income for remaining life of members.

An important ingredient in the adjustment of pension system and its sustainability for an aging population is undoubtedly financial literacy and transparency. Information and its accessibility should be available as to allow individuals to assess the contribution of the different types of schemes to retirement income and to understand product, cost and risks. It is particularly important in this regard to establish greater transparency with respect to PAYG possibilities.

The impact of design of pension reform on labor market and vice versa is important. Pension reforms have change incentives for older workers by removing incentives for early retirement, extending working life, and introduction of financial incentives. However an important avenue to dwell is the pension reform design affect individual behavior, particularly labor supply. Undoubtedly clarifying the retirement benefits from PAYG systems contribute to streamline labor incentives and perception as what part of the social security contributions are not tax or not promises (i.e. enhances perception of the link between contributions and benefits). However, equally important are well managed funded pension contributions and adequate replacement rates. Expensive, risky and inefficiently managed compulsory contributions can be perceived as a tax and thus also discourage labor participation and effort.

Another important avenue for exploring links is ensuring consistency of current labor market reforms and pension reform, for example reducing social security contributions at low-wage level can act against the very purpose of ensuring retirement income for low wage earners. More broadly while payroll tax can be perceived as distortion it nevertheless provides protection against reduced consumption in old age which can not be neglected taking account individual myopic behavior and financial risks enhanced by the very issue of aging.

Pension reform and behavioral response needs deeper analysis. For example it can be argued that when income is higher the marginal value of social protection declines and distortion might arise but it is not clear on the other hand whether labor supply will increase by reducing payroll tax.

Similarly, this issue has to be looked in the context of longer expected life of high income earners.

Reforming PAYGO system can have an important effect on individual savings when accompanied by a shift to a mixed system with individual accounts. However, what is less certain in open economy model is its contribution to growth particularly in the highly integrated EU financial market. Nevertheless, partly funding pensions as a means of diversification of retirement income source and higher return that PAYG can contribute to offset reduction in replacement rates and streamline labor incentives. However, for the market to deliver its contribution well design funded pensions schemes are needed. In this regard the Forum could be well dwell on critical design issues such as: charges, discontinuity in contributions, investment strategies, investment performance, fund anuitisation, provider incentives and regulation.

The development of funded system is an important integral part of whatever pension reform and as such hinges primarily around the level of pay roll tax rates and its split among retirement income sources. Probably this is the best way to encourage the growth of private pension savings. The use of tax breaks to encourage voluntary private savings should be look in light of the additional burden resulting from tax revenues to the already strenuous fiscal challenge, its targeted groups and in light of its consistency with the overall deign of pension reform.

Financial and social sustainable reforms resting on prolonging retirement age and retirement income source diversification depends on the burden sharing among current and future pensioners. In this regard intergenerational consensus is a must. I am sure the deliberations of this important Forum will contribute to this end.