Position of the CBR: Recovery and resilience plan for Slovakia: Sound, sustainable and competitive public finances

Commitment to pension reform

The Slovak government committed in the recovery and resilience plan (the „RRP") to improve the sustainability of the pension system (Component 18, Reform 1).

According to the COUNCIL IMPLEMENTING DECISION on the approval of the assessment of the recovery and resilience plan for Slovakia (ST 10156/21 page 7) "***the pension reform is expected to make Slovakia less vulnerable to sustainability risks***."

It further specifies (ST 10156/21 ADD 1 page 170) that:
"*The pension reform **shall improve the long-term fiscal sustainability of the pension system**. To this end, it shall link the retirement age to life expectancy, and abolish retirement age caps. It shall moreover ensure entitlement to an actuarially neutral benefit after a minimum number of years worked…*"[1]

Part of the pension reform, namely the amendment to the Social Insurance Act (pay-as-you-go pension pillar), shall, according to the Operational arrangement between the European Commission and Slovakia (page 134), enter into force by the end of Q4 2022 with effect from Q1 2023, and should include:
"1) linking increases in retirement age to increasing life expectancy,
*2) introducing an **entitlement to actuarially neutral benefits from the first pay-as-you-go pension pillar for persons after a statutory minimum number of years of service** ".*

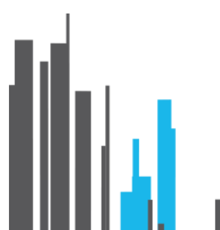
Early retirement pension vs actuarial neutrality

According to the current legislation, the entitlement to an early retirement pension arises **no earlier than two years before reaching retirement age.** For every 30 days before retirement age, there is a **penalty for early retirement of 0.5%,** which is approximately 6.1%[2] in annual terms.

The Slovak Parliament approved the reform (amendment to the Social Insurance Act) of the pay-as-you-go pension pillar (the „reform") on October 5, 2022.

The reform relaxes early retirement conditions by **introducing an additional option for early retirement pension after a minimum period of employment[3] (40 years)**. For those early retirees who meet this condition, an alternative, lower penalty of **0.3% for every 30 days** before retirement age (i.e., an average of 3.7% per year) was introduced.

[1] Only part of the pension reform's measures, related to the pay-as-you-go pension pillar pay, is listed.
[2] Annual early retirement penalty=(roundup((365*y)/30; 0)*0.5%)/y where y is the number of years before retirement age.
[3] Despite its name, this period also includes the period of childcare (maternity and parental allowance).



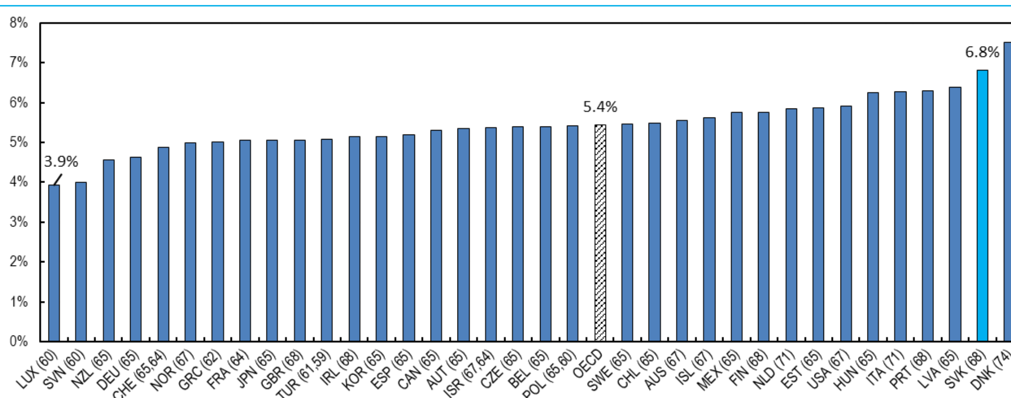
Those early retirees who do not meet the condition of 40 years will have their early retirement reduced using the current, higher penalty.

Position of the Council for Budget Responsibility on the actuarial neutrality

According to the Council, **the introduction of two alternative penalties for different categories of early retirement is unjustified**. The principle of actuarial neutrality should be applied equally to every type of early retirement.

Moreover, the newly introduced lower penalty for early retirement after 40 years of service (0.3% per 30 days ≈ 3.7% per year) **violates the actuarially neutral reduction condition.** OECD estimates that the actuarial neutrality for Slovakia[4] is 6.8%, which roughly corresponds to the current penalty (0.5% per 30 days ≈ 6.1% per year). The adopted lower penalty (3.7%) is even outside the range within all OECD countries (3,9% is the minimum).

Figure 1: Actuarially neutral annual bonus on past entitlements at the normal retirement age[5]



Normal retirement ages are in parenthesis on the x-axis.
Source: OECD pension models.

Source: OECD, Pensions at a Glance 2017

Using the same methodology as OECD (Queisser and Whitehouse, 2006), the Council reached the same conclusion, that the actuarially neutral penalty corresponds to 6.8% per year.

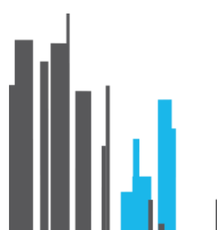
Lower than actuarially neutral penalty will lead to an unfairly higher pension claims over the remaining lifetime, will increase a motivation for an early exit from the labour market and thus will contribute to the deterioration of the long-term sustainability of public finances.

As part of the legislative process, in August 2021, the Secretariat of the Council proposed to maintain the current penalty for early retirement (0.5% per 30 days ≈ 6.1% per year) uniformly applied to all early pensions.

---

[4] The reintroduction of linking the retirement age to life expectancy (approved reform) is consistent with the assumptions used in the OECD calculation (in Pension at a Glance 2017 – Figure 1).

[5] Differences in actuarial neutrality between countries are caused mainly by two factors: 1/ expected time in retirement (retirement age, life expectancy) 2/ generosity of pension indexation mechanism. The shorter the expected period spent in retirement and the more generous the indexation mechanism, the more weight is given to leaving 1 year earlier, and therefore the penalty must be higher.



During the same legislative process, in addition to the Secretariat of the Council, also the Ministry of Finance and the National Bank raised similar comments:

*"...**National bank of Slovakia** proposes to change the penalty for early retirement pension from 0.3% to 0.4% [per 30 days]. Justification: We consider the value of 0.3% to be insufficient for achieving actuarial neutrality." ([Vyhodnotenie pripomienkového konania](), page 95).*

*"We [**Ministry of Finance of the Slovak republic**] request that the current penalty for early retirement pension [0.5% per 30 days] be maintained even if the condition of 40 years of service is met. ... The mechanism of reducing the early old-age pension affects the motivations to remain on the labour market. If the condition of 40 years of work is met, it will be possible to retire more than two years before reaching the retirement age (currently it is two years at the earliest). Therefore, **the early retirement penalty should be at least the same, if not higher, than the current one [0.5%]**..."(Vyhodnotenie pripomienkového konania, page 58).*

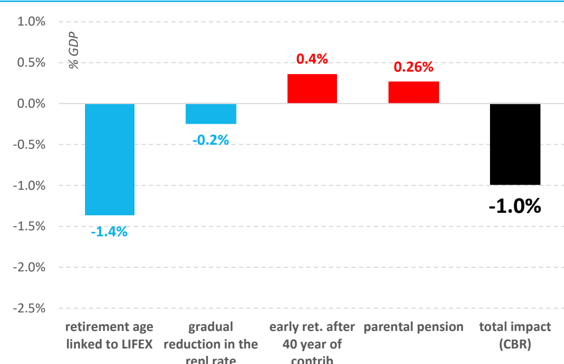
The Ministry of Labor, as the drafter of the amendment to the law, responded to all of the above-mentioned comments uniformly: *"According to the calculations of the Ministry of Labor and Social Affairs of the Slovak Republic, the penalty of 0.3% corresponds to actuarial neutrality." (Vyhodnotenie pripomienkového konania, pages 35, 58 and 95).*

Position of the Council for Budget Responsibility on the long-term sustainability

In October 2021, the Council published a complex costing and assessment of the reform proposal, where, in addition to the above-mentioned reservations regarding actuarial neutrality (page 28), the Council looked closely at the impact on long-term sustainability.

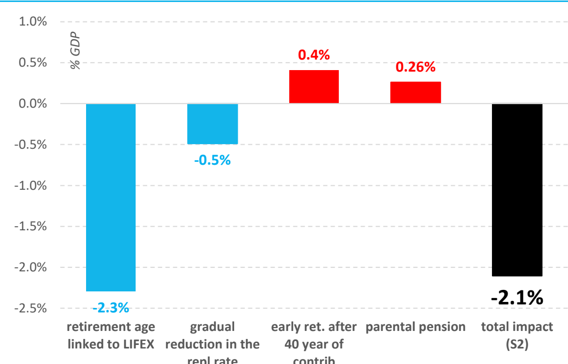
The Council concluded that "*the reform proposal formally improves the long-term sustainability of public finances according to the national methodology (50-year horizon) by 0.8% of GDP*" [the current estimate is 1% of GDP due to the reduction of the generosity of the parental pension in the approved reform[6] - Figure 1].

Figure 1: Impact on long term sustainability indicator – national methodology



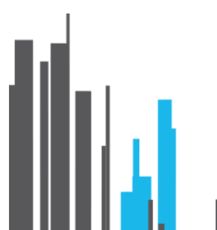
Source: CBR

Figure 2: Impact on long term sustainability indicator – S2 methodology



Source: CBR

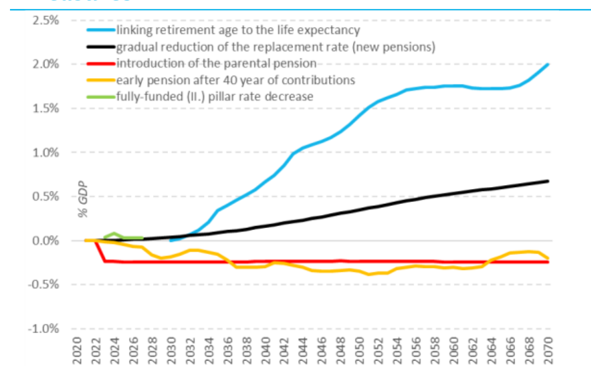
[6] Current CBR's estimate of sustainability indicator improvement (the national methodology). In terms of S2 indicator, the improvement is estimated at 2,1% of GDP – Figure 2.



At the same time, the Council pointed out the risks associated with fulfilling the goal of improving long-term sustainability:

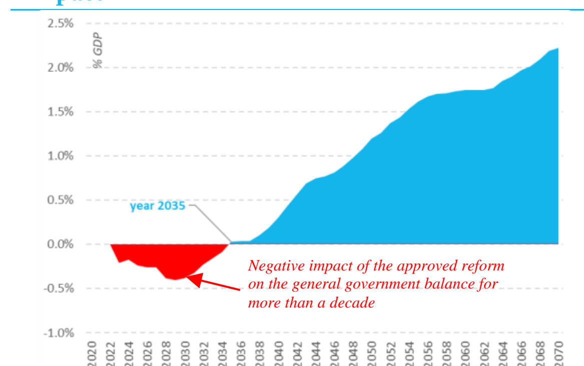
"*Although the draft law formally improves the long-term balance of the pension system, the structure of the measures [Figure 3], a different strength of their legislative protection and additional measures envisaged directly in the constitution generate* ***significant risks that may ultimately lead not to an improvement in long-term sustainability, but in an extreme case to a deterioration****.* " (page 6).

Figure 3: Fiscal impacts of the approved reform of the 1st pension pillar (% of GDP) – individual measures[7]



**Impact on balance* *Source: CBR*

Figure 4: Fiscal impacts of the approved reform of the 1st pension pillar (% of GDP) – aggregate impact



**Impact on balance* *Source: CBR*

"*The Council points out that the above-mentioned improvement in the long-term sustainability of public finances [of the pension reform]is associated with significant risk and therefore may not be achieved. On the contrary, an unintended consequence of the adoption of the draft law may be a significant deterioration of long-term sustainability. The reason is that* ***the measures, which are supposed to reduce pension expenditures in the future, are adopted by an ordinary law****, and thus can be modified or cancelled by a simple majority in the parliament at any time. On the other hand, the existence of* ***measures that increase pension expenditures immediately[8] is guaranteed by their constitutional anchoring[9].***" (page 47).

Despite the reduction in the amount of the newly introduced pension benefit (parental pension) in the approved reform, the above-quoted statement by the Council continues to apply.

[7] Current CBR's estimate.
[8] Introduction of the parental pension, the introduction of entitlement to actuarially neutral benefits from the pay-as-you-go pension pillar for persons after a statutory minimum number of years of service.
[9] The Constitution of the Slovak Republic enshrines their existence but does not define the extent of their generosity.