Implementing *Individual Pension Accounts* in the Third Pillar of Slovenian Pension System

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Summary

The Slovenian population is exposed to risk of a dramatic decline of pension benefits. The existing pension system is almost exclusively based on the pay-as-you-go pillar and thus on inter-generational social contract. Like elsewhere in fast ageing Europe, the system is put under a severe demographic pressure and balancing social security contributions with ever-increasing pension benefits will be increasingly difficult. In the absence of a fundamental pension reform that would strengthen private pension pillars, Slovenia will increasingly face a dilemma to either increase public debt or to cut pension benefits.

Policymakers should thus focus on introducing well-designed private pillars. The purpose of this monograph is to present an innovative idea about how to design and implement *Individual Pension Accounts*, the accounts that would form a so far non-existing third pension pillar (i.e. the pillar that aims to provide incentives to save for the retirement to individuals). In Slovenia, the second pillar (i.e. the pillar that provides tax-supported mechanism to employers which can decide to pay certain percentage of employees' wage into their private accounts) was introduced in 2000, but it is governed and managed in inefficient way and has only accumulated modest resources. Under conducive incentive structure to be set up by the Government, *Individual Pension Accounts* would provide an important vehicle of savings for today's younger generation, especially those with middle-level pay. Without such a system, this generation is doomed to fail to generate substantial savings during their working careers. The monograph presents arguments in favor of such accounts, hopefully helping to persuade the Slovenian government to set up such a system.

The key novelty of the monograph is to base the complete design of *Individual Pension Accounts* on existent financial products and institutions, while making sure that the system is simple and transparent. There are two crucial conditions for a successful implementation of this system. The first relates the financial intermediaries, which should serve as custodians of the pension assets held on the segregated *Individual Pension Accounts* and should thus act according to prudent person principles. The second is setting up a tax registry, which would allow tracing all the flows within the system and serve for the required reporting.

The advantages of the *Individual Pension Accounts* – resting upon principles and best practices that have evolved in the developed world – are as follows. First, the new system would provide people an additional layer of diversification of their income in old age. Second, it would help build awareness of the unsustainability of the first pillar in thus create incentives to work more and save. Third, it would result in greater fairness regarding the inter-generational distribution of burdens faced by demographic shifts. Fourth, the system would bring greater flexibility about the timing of retirement. Fifth, tax credit calibration

could be made in a way that system could provide greater coverage (i.e. that even lower-paid individuals would be motivated to save). Sixth, the design would allow pension assets to be freely portable. And finally, system would allow any degree of self-involvement of individuals regarding the choice of financial products.

Individual Retirement Accounts would not only have beneficial effects connected to providing an additional income to the elderly, but would also accumulate much needed aggregate national savings which would benefit financial markets and impact economic growth and welfare. The financial markets would be able to provide more efficient allocation of capital and help strengthen corporate governance, which is still overwhelmingly influenced by the politicians and their vested interests.

This monograph consists of six chapters. After the introduction, the second chapter summarizes the literature on private pension vehicles for both developed and developing countries. The third chapter provides an overview of the size and the relative importance of private pensions. This chapter presents third pillar frameworks in the ten selected countries. Forth chapter presents principles upon which private pension systems are built and best practices in the third pillar systems. In the final, fifth chapter, the monograph presents the idea of the third-pillar system in Slovenia and a suggestion of its implementation into the existing national financial system in the last one.