

## **Solidarity pension systems will not disappear, but will undergo serious reforms**

*Interview with Daniela Petkova, Chair of the Management Board of PAC Doverie, published in Capital Weekly*

### **Profile:**

*On 26 February 2013 the world-famous economist Nouriel Roubini will deliver a public lecture in Sofia. Mr. Roubini was invited to Bulgaria by PAC "Doverie AD". Professor Roubini, one of the few who predicted the global crisis, will discuss the topic "Growth Opportunities for Small Economies in the Globalized World". In relation to his upcoming visit, we talked to Daniela Petkova, Chair of the Management Board of PAC Doverie, who manages the supplementary pension savings of over 1.25 million workers totaling more than 1.7 billion BGN. Here is her opinion on how Bulgaria managed to prove wrong Roubini's gloomy forecasts about the Bulgarian currency board, our country's future prospects and the biggest challenges facing the pension system.*

**Doverie invited Nouriel Roubini known as one of the biggest pessimists among economists and economic analysts worldwide. What do you think he would say about Bulgaria?**

If we take a closer look into Roubini's economic analyses and papers and try to forget about his reputation, we can easily say that his pessimism is being blown out of proportion in a sense. I have no idea what he is going to say about Bulgaria in his lecture. Our goal behind this public project was namely to invite a globally recognized scientist such as Roubini to focus his and his team's attention on our country's economic indicators and give an opinion on the outlook for Bulgaria's development in the global economy and on the risks the country is facing.

**Back in 2009, at the onset of the crisis, Mr. Roubini predicted that Bulgaria would face serious economic troubles, possible currency devaluation coupled with a collapse of the currency board. How do you think we managed to prove him wrong?**

Probably his forecast about Bulgaria drew upon his overall opinion of the currency boards in general, currency rates and the need to devalue some of them. I hope that during his lecture he will tell us more about these views and their relevance in the current situation, and he will speak about the possible future scenarios for the euro and the other currencies, whether we can expect rising inflation rates, etc. Nevertheless, as far as Bulgaria is concerned, so far the facts have proven him wrong.

**I agree, but what is it that Bulgaria has done to prove his forecast wrong, assuming that his projections were well-founded?**

Perhaps what he couldn't possibly estimate was the fiscal stability in Bulgaria that has been maintained for far too long, and all this at the expense of a significant decline in the population's standard of living, especially having in mind its low levels before the introduction of this policy. Probably his forecast did not take into consideration also the far too healthy and conservative policy maintained by the central bank vis-à-vis the capital adequacy, liquidity and the general stability of the banking system in Bulgaria.

**Didn't the European funds have a certain role to play in this? In effect, the growth in Bulgaria over the recent years, if any, was generated mainly due to the transfer of funds from the EU?**

I don't know whether Roubini considered this when making his projections for Bulgaria, but it is true that the Euro funds are among the key stabilizing factors in the Bulgarian economy,

and they have been driving the reported growth, no matter how small. The European funds are certain to continue playing a major role in the coming years and it is key to ensure that this funding is not jeopardized in any way. If possible, it would be good to increase the absorption rates by limiting the bureaucracy and the scandals accompanying the implementation of the European Programmes.

**Can you see any threats in this situation, namely that the Bulgarian companies may get accustomed or even addicted to the European funding, part of which comes in the form of grants, and engage in competition for a bigger portion of this funding rather than with one another?**

This risk is very relevant, even more so in times of crisis. I truly hope that the Bulgarian businesses will not get dependent on this funding. The bigger threat is that they might get accustomed to the red tape that is currently part and parcel of the European funding. There will be companies who will try to benefit from the current status quo and rely mainly on funding coming from such programmes without using this time and opportunities to develop their own infrastructure for good market practices. Such companies will face difficult challenges when a certain programme in whose projects they have specialized closes down or cuts its budget.

**Your industry is among the most forward-looking. So, from a long-term perspective, what are the biggest strategic challenges lying ahead of the Bulgarian economy?**

I hope this will be one of the topics Mr. Nouriel Roubini will cover in his lecture. He himself, along with many other leading economists, agrees that one of the factors that triggered and exacerbated the crisis was namely the shortsighted vision of the capital and financial market players, their constant search for maximized short-term profit neglecting the long-term investment goals. This is one of the dilemmas before the pension funds, crisis or no crisis – whether to seek maximum short-term yields or to rely on a long-term investment policy ensuring a much greater stability aiming to achieve the ultimate objective, namely to preserve the value of the money over the entire contributory period, which is around 40 years for each worker.

Therefore, in answering your question, I would say that there certainly are many challenges facing the country's economy, but among the most significant ones is to place economic and political focus not only on the short-term vision restricted to the duration of a government's term of office, but also onto the longer-term goals and development strategies ensuring sustainability and growth for the country. This would not be easy, because a lot of short-term problems have added to one another. These are all pressing matters and while addressing them, we do not have time for the longer-term strategic thinking, actions and reforms.

**Probably one of the most serious problems in Bulgaria, and in your particular industry, is demographics. Against the backdrop of the statistical projections, do you think that the pension system in its current form may remain sustainable, or does it need some radical reforms?**

Regarding the demographics, both in Bulgaria and the EU, there are some very unambiguous trends with a direct bearing on the pension systems. On the one hand side, there is the overall ageing of the population, advanced maternal age, and longer average post-retirement life-expectancy. This triggers a very serious debate about the future of the social systems in general, and about retirement provision in particular, not only in Bulgaria, but in the EU as well.

The two key factors – the crisis in combination with the negative demographics – affect most seriously the PAYG schemes. In the best case scenario, some of these schemes resort to perfecting the systems and adapting to the new environment. In worse cases, the proposed

solution is increasing the retirement age. And the worst case scenario (relevant, I am afraid, to the Bulgarian situation) is when the system undergoes complex changes, which can rather be defined as radical reforms. The solidarity pension systems may not cease to exist and cannot be closed down, especially in old Europe. This form of retirement provision is an instrument through which governments meet their obligations to the population, especially in terms of social protection. It is true that in the recent years, the solidarity systems generate significant deficits as a result of the crisis and the negative demographics; however, the governments are obliged to cover these deficits, incl. by using other sources of funding. And here is the vital role of the experts to offer correct medium-term and long-term demographic projections in order to prepare the population and the country's fiscal system for addressing the future deficits, which are expected to grow even further. I am expecting that in the near future the governments will be obliged to announce in advance the estimated future deficits in their social security systems accounting for the relevant demographic trends in the respective country. All this might affect the countries' credit ratings.

In Bulgaria in particular, the demographics are even more complicated since there are additional factors such as emigration, higher mortality rates in active age (a direct consequence of the situation in our health system and the lower standard of living), higher childhood mortality, many years of negative growth, etc. The situation is aggravated even further due to the harsher impact of the crisis on the population, compared to other countries – increased poverty, higher unemployment rates, freezing of the income, and a growing number of discouraged people. All this creates a vicious circle, because in such situations emigration is on the rise, the birth rates decrease and hence the negative demographics. In general, the pension system in Bulgaria with its three-pillar model is stable, due to the diversification between the solidarity principle, the mandatory form of supplementary retirement provision based on defined contributions and the voluntary pensions with tax incentives ensured by the government. It is good that Bulgaria does not have a defined-benefits system and has therefore been spared the problems experienced by DB systems in the old European countries. The balanced weight of the three pillars is the key to a stable and effective system.

### **Nevertheless, the pension system is anything but free from challenges?**

Each pillar experiences problems in different periods of its development, and right now all three of them are seriously affected by the crisis. The solidarity pension scheme is incurring huge deficits and it is high time the government admits officially that it is more than just a pension scheme (which would be natural in light of the demographics and the crisis), and that some of the system's internal regulation and mechanisms need to be changed in order to stabilize and reduce the mid-term and long-term deficits.

The second pillar is already recovering from the negative yields in 2008. Statistics show that in nominal terms they have already been compensated, and now the schemes are balancing also the real return compared to the inflation for the entire period of their existence. We stand a good chance here. The pension funds are young and have sufficient time before the start of the pay-out period. In this respect, our members were not affected directly by the crisis. They have not capitalized any of the losses from 2008, because the pay-out period hasn't started yet.

The negative impact of the unemployment and low income (which has even been frozen, to make matters worse) is most obvious in the third pillar. People feel too insecure about their future to think about saving part of their income long term. They rather save money because of fear, but in a way that would allow them to withdraw it when needed, and this can only be achieved through bank deposits.

**In other words, you are saying that if some of the changes you have insisted on for years are introduced, the present model can survive despite the estimated growing deficits in the solidarity pillar caused by the demographics?**

The deficit in the solidarity pillar is also due to the crisis. We needn't forget that a big portion of this deficit was incurred because fewer people pay contributions, which on the one hand is a direct consequence of the demographics, and on the other results from the unemployment. The model will endure, but this wouldn't matter, if it does not work towards ensuring an increase in the pension benefits. The low benefit rates in our country have long ago turned from simply a problem for the retirees and their families, into one of the factors preventing a more significant economic growth.

**And in the meantime there is the social tax evasion?**

Yes, and it has aggravated due to the crisis. Right now this problem could hardly be solved, no matter what measures are being introduced. Even if everyone who doesn't pay contributions is sent to jail, they will still refuse to pay. People contribute as much as they have. Some evade the social tax deliberately; others are simply trying to survive. I am not against taking measures, but punishment through imprisonment, and all that in times of crisis, is going a bit too far. We should rather analyze and address the root causes for non-compliance, and not so much the problem itself. We shouldn't underestimate the fact that workers are aware of the meager benefits paid out of the solidarity pension fund and this serves as an additional disincentive for compliance.

**What is your take on the political risk that some of the future governments might decide to address short-term issues in a more radical manner, e.g. through nationalization of the pension funds following the Hungarian example?**

I sincerely hope that the Bulgarian people will never elect such leaders whose policy would allow even the thought of nationalizing any private property, including the savings for second pension. The pension system does need daring solutions, but nationalization of the second pillar is not one of them. As I mentioned, the key to the system's sustainability is in its diversification. To opt for a concentration and go from a three-pillar to a two-pillar or even worse – one-pillar system, would mean to put its sustainability at stake. All things aside, such an intervention will not result in removing the root causes for the present condition of the PAYG pillar, nor will it solve the issue with the low benefits of today's retirees. Yes, a political party may spend a much more comfortable term of office using the worker's money accumulated in their individual accounts, but God help the next government, the pension system, and Bulgaria.

I don't think that the Hungarian scenario is recommendable for Bulgaria, not only in the area of pensions, but in general terms! Hungary is already paying dearly for its government's decisions. This conclusion was stated explicitly in a report by one of the credit rating agencies, which is a quite unusual practice. It would be good to wait and see what the future holds for Hungary, incl. a decision by the European Court of Justice, which has been petitioned on this matter. I strongly hope that we will not have to go through the Argentinean scenario either - Argentina was brought to the verge of bankruptcy, and the government resorted to extreme measures to prevent this from happening, incl. nationalization.

**In an interview for Capital Daily, Deputy Prime Minister Simeon Dyankov said in relation to the possible introduction of competitive private health insurance funds, I quote: „Up until now we have no evidence that the introduction of private pension funds in Bulgaria has helped the sector in any way, or at least I can't see any. In my opinion, the opposite has happened. These schemes are in fact well-paid intermediaries who try to keep the status quo unchanged." What is your response to this criticism?**

I would answer with a question to Mr. Dyankov. Why does he think that the society, the state, the sector, etc. only benefit from money that goes directly into the budgets managed by him? Up until now, the Bulgarians have accumulated some 6 billion in personal pension savings, and this wouldn't have been so unless we had the second pillar of retirement provision and the private pension funds. Why does he think that people do not benefit from having more money which only they themselves are entitled to by law?

What he calls "well-paid intermediaries" trying to preserve the status quo are in fact companies that not long ago invested millions of euro of overseas capital to meet the mandatory requirements, companies that in order to start up their operations as "intermediaries" and later on have created thousands of jobs. These companies provide additional income to tens of thousands of individuals, pay their taxes and fall in the group of large tax payers. In their specific line of business they have ensured that the investment yield allocated to the pension funds managed by them, i.e. to the individual accounts of the workers, significantly exceeds the charges from fees. I can only wonder why our minister of finance is not interested to ensure that all other sectors, incl. health care, become more like the retirement provision industry – with foreign investments, operational and profitable companies, significant number of jobs, regular payment of wages, social security and tax compliance, sizeable fees paid to the government institutions, etc. And not only that, in addition, this sector makes a real contribution to increasing the population's savings, which will bring about higher post-retirement income.

**Without trying to be the minister's advocate, I guess, he would respond that the savings could have exceeded 6 billion, had there been more competition and lower fees...**

- Yes, but this is a different matter. The first debate questions the existence of the second pillar as such – in Mr. Dyankov's words, our society sees no real impact from the 2<sup>nd</sup> pillar and he suggests that the worker's own money (6 billion) be taken away from them, pooled into the governmental budget or the public social security's budget to be used by the government and not by the workers themselves. I myself can't understand how our society could possibly be better-off after such intervention. The second debate relates to the performance of pension companies. We need to put a clear demarcation line between the two, because they are being mixed up quite manipulatively. Yes, there will always be room for criticism, if we consider the operations of a specific business organization, including the pension companies. We can criticize the legislation and the government's most recent attitude towards this sector. However, all these issues are different from questioning the benefits from the second pillar of the pension system and denying the actual results achieved by the so-called intermediaries.

**Interview by Nikolay Stoyanov**

*Photo - „I am afraid that Bulgaria is one of the countries with worst demographics.“*