Associate Professor Bogomil Manov, PhD

DEFICIENCIES IN THE STATE PENSION SYSTEM AND THE SILVER FUND

The article deals with the nature and sets out an analysis of the current pension system and the Silver Fund in Bulgaria. It also outlines the prospects for its development in the future. The Silver Fund is a part of the pension system by virtue of its very purpose of guaranteeing the stability of the State pension system.

JEL: J26; I38

Establishment and development of a pension system in a modern market economy

In Bulgaria, the transition from a socialist, centrally-planned economy to one based on free market principles has created a number of financial problems with implications for the reproduction of the individual, the collective and society. From the very onset of the transition period apprehensions have been voiced that addressing the issue of the sustainability of the pension system will be protracted and challenging and that the price will ultimately be paid by the labour force, capital and society. The only questions that remained unanswered at the beginning of the transition period were how long the process was going to be and what price would society pay.

During the period in question the insurance system operated at a loss with a high relative number of pensioners who, objectively, are not a productive part of society. Problems in relation to their subsistence have occurred and still need to be addressed. The anticipated crises have imperatively called for creating buffers with a view to ignoring the sharp fluctuations in the amount of the funds paid into the insurance system. Such a buffer was the Silver Fund.

The transition period put the entire insurance system under enormous pressure. The pension system had and continues to have a central place and the changes to it were rightly the subject of broad social, economic and political debates. In general terms, the goal of the system was to objectively raise the standard of living of pensioners who make up 26 percent of the entire Bulgarian population through a combination of mandatory – from the point of view of reproduction security – and voluntary pension insurance.

The appraisal of the changes undertaken during the twenty-year transition period shows that reforms fall short of the expectations of society and the requirements for a functioning market economy. Is this so because they were partial in nature; were not well thought out; or were not consistently applied? Or is the answer a combination of the two? Seeking to address these issues led to a large-scale reform, which was launched in the middle of the ongoing transition period in the form of expanding the scope and altering the model of the pension system.

In parallel to mandatory state insurance a private insurance system was designed and set up, so that the current insurance system has three pillars (layers). The first one known as the public social insurance pillar has existed for a long time having been set up in the period of the centrally-managed (planned) economy. That pillar was called on to cover approximately two-thirds of pensions. It is essentially based on a pay-as-you-go principle. The second pillar, known as the additional mandatory pension insurance, was to be based on the principle of private accounts. Two funds were set up under the second pillar – a Universal Pension Fund (UPF) and a Professional Pension Fund (PPF) whose aim was to allow a significant amount of capital to accumulate, which would cover approximately half of the remaining one-third (approximately one-sixth) of pensions. The two funds were established in 2001 and 2002. The UPF was set up for the younger generation only, born after 31 December 1959 and the PPF – for those working in difficult and hazardous conditions (approximately 180 000 workers). The other half of the remaining one-third will be available only to those pensioners, who can afford saving for old age. For this group, the third pillar known as the additional voluntary pension insurance was set up as far back as 1994, i.e. prior to the 2000 reform of pension insurance. According to expectations at the time the goals of the reform would be achieved over a period of 20 to 25 years.

The goal of the reform of the first pillar was to eliminate the accumulated deficit and gradually shift the pension burden to the second and third pillars. At the same time all governments have followed a highly inconsistent policy limiting its funding, which ultimately meant that the pillar concerned was underfunded over the years. At the beginning of the current century the government came to realize that it was no longer possible for the pillar to continue functioning in a situation of financial instability, which precipitated a number of changes. One of them was to set up a special fund designed to ensure the financial stabilisation of the first pillar.

Establishment and development of the Silver Fund

A Silver Fund has been set up and functions in a number of European countries with identical problems revealed in their pension systems – France, The Netherlands, Belgium, Italy, Spain and Portugal. In Bulgaria it was set up on the basis of the models adopted in these countries. The Silver Fund was provided for in the transitional and final provisions of the 2006 State Budget Act.[1] Its exact name is State Fund Guaranteeing the Stability of the Public Pension System. At the end of October (on 30th October to be precise) the National Assembly enacted a special law on the fund. In the public domain it is known as the Silver Fund similarly to its name in other countries. The symbolism in the name has a direct link to the intended purpose of the funds to be disbursed on pensions for people with white (silver) hair.

[1] For more information see the 2006 State Budget of the Republic of Bulgaria…

When the fund was set up two conditions were formulated: that it functions on the basis of private accounts and that it is to accumulate sufficient funds to ensure the stability of the pay-as-you-go system. Private pension insurance functions along similar lines. However, when the Silver Fund was set up the idea of setting up a private account for each insured person was rejected.

The sources from which funds were to be accumulated were defined, notably 25% from the budget surplus; 90% from the income from privatisation; concession fees and write-offs and other amounts of lesser significance. The minimum period for accumulation of funds was set at 10 years. The aim of the solution was to support and ensure the stability of the pension system.

The table below helps us better understand the development and achievement of the target for the funds to be accumulated in the State Fund Guaranteeing the Stability of the Pension System (Silver Fund) over the period from its establishment until the end of the second quarter of the current year and the distribution of those funds:

Table 1

Income by year (million BGN)	2007 г.	2008 г.	2009 г.	2010 г.	2011 г.	2012 г.
1. Funds transferred from the central budget	211.8	841.5	540.0	140.0	0.0	310.1
2. Interest on deposits	4.3	16.7	9.0	13.4	0.0	0.0
Total funds:	216.1	858.2	549.0	153.4	0.0	310.1
Deposits with BNB	*216.1*	*1074.3*	*1623.3*	*1683.9*	*1776.7*	*2086.8*

Source. www.minfin.bg

The data in Table 1 show the following trends and characteristics in the development of the Silver Fund:

First, as at 30 September 2012 the total funds stood at 2 086.8 million BGN. They have been accumulated over a period of six years or the average annual transfers into the fund have stood at approximately 350 million BGN.

Second, over the years the amounts of the transfers have varied. They were the highest in 2008 – 841.5 million BGN, followed by 540 million BGN in 2009 and 310.1 million BGN in the first six months of 2012. The first two years in which the country began to experience the effects of the financial and subsequently economic crisis and the last year (2012) in which the country's economy was in recession have had a strongly negative impact on the sources of funding.

Third, the entire amount accumulated in the fund was invested in a single instrument – a deposit with the Bulgarian National Bank (BNB). Non-diversification always generates a systemic risk.

Fourth, the rate of return remains low. At present the invested capital of the Silver Fund generates an interest of merely 0.2 percent. By way of comparison the annual return on an investment in Bulgarian treasury bonds is 5.35 percent.

Fifth, the accumulated funds are highly insufficient to ensure the achievement of the goals of the fund. The amounts accumulated to date would be sufficient to pay out pensions for less than 4 months (3.43 months) in 2012. This means that the instrument is hardly in a position to guarantee the stability of the pension system functioning on a pay-as-you-go basis (the first pillar).

What are the reasons for these negative trends and what is the impact of the delay in establishing the Silver Fund on the achievement of the goals of the pension reform?

The answer to these questions should be sought in the overall development of the pension system and its constituent pillars following the reform undertaken in the year 2000.

First pillar of the pension system

Regardless of the relatively short period during which it has functioned, the following positive trends in the set up and management of the mandatory public pension insurance system can be highlighted:

•Providing the possibility to make long-term payments into a separate fund and defining the precise scope of the payments. The removal of the old system of making long -and-short-term payments into a Public Insurance Fund;

• Providing the possibility to set aside reserves as a necessary step towards a transition from a pay-as-you go financial arrangement to a pension coverage system;

• Adopting the principle of a self-financing fund as a necessary condition for viability and stability. As a result, achieving a higher substitute level of the average pension per retiree as a share of the average national insurance income measured through the income substitution index. In the period between 2002 and 2010 a stable trend towards an increase of the money paid into the fund has been observed (see Table 2). However, it should be taken into account that the fund does not fully cover the level of substitution because it does not take into account the contributions towards the additional mandatory and voluntary insurance, respectively.

The income substitution index for the period 2002-2011 is shown in Table 2.

Table 2

	Year									
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Pension paid vs. average net monthly insurance income	49.93	49.63	50.97	51.63	53.30	54.00	53.32	56.28	58.39	57.30
Pension paid vs. the average gross monthly insurance income	39.38	39.41	40.40	40.60	42.90	43.10	41.75	44.06	46.19	44.90

Source: Social insurance in Bulgaria in 2010, p. 229; Social insurance in Bulgaria in 2011, p. 156…

• Ensuring a gradual transition to the new retirement system; a relatively gradual increase of the length of service and the retirement age in order to mitigate social tension and allowing for a gradual adaptation of the workforce to the new retirement system;

•Adopting the tripartite principle in the management of the pension fund through stakeholder involvement in the insurance process thereby fostering greater trust in the mandatory pension insurance system;

•Introducing pension contributions that are covered by the insured person. According to the adopted model contributions are split between the insurers (employers) and the insured (workers and employees) in a certain ratio – 75:25 in 2004 and increasing by 5 percentage points for the insured each subsequent year so that it reached 60:40 in 2009. The objective is to ensure the insurance weight is shared equally (50:50) between employers and workers in the future as an incentive aiming to boost employer investments.

•Higher requirements for length of service during which insurance contributions are made prior to retirement. This is expected to partially offset the negative demographic trends in Bulgaria and lower the insurance burden on economically active persons. Over the period 2001-2010 a trend towards a decrease of the support ratio, also known as the pensioner figure, has been observed;

•Removing the upper limit of pensions in the long-term and tying in the minimum pension to the social pension amount;

•The intended removal of the current ceiling capping the maximum insurance income to be replaced by the possibility for each worker to pay insurance on the basis of their actual income should be seen as a positive development.

What results did the pension reform achieve over this relatively short period? A summary is set out below.

•*Relatively low pensions*: in comparison to most countries in Europe pensions in Bulgaria are low – in the first decade of the 21st century their share of GDP remains below 10 percent. In most economically developed countries, following retirement the pension received is two-thirds up to three-fourths of their income in the last few years prior to retirement. In Bulgaria that ratio is about fifty percent of the pre-retirement income. In the last decade a trend towards greater dynamics and growth in real terms of the average pension per retiree has been observed. However, the rate of increase has not been sufficient to raise the standard of living of pensions to that of their counterparts in developed countries.

Low pensions are primarily due to the low insurance contributions whose level was consistently decreased over the last ten years. In 2006 alone the contribution paid into the State Pensions Fund was decreased on several occasions. It is considered that as a result of these reductions Bulgaria has lost over 10 billion levs of cumulative income, which amount is approximately equal to the deficits covered by the annual subsidies from the state budget.[2]

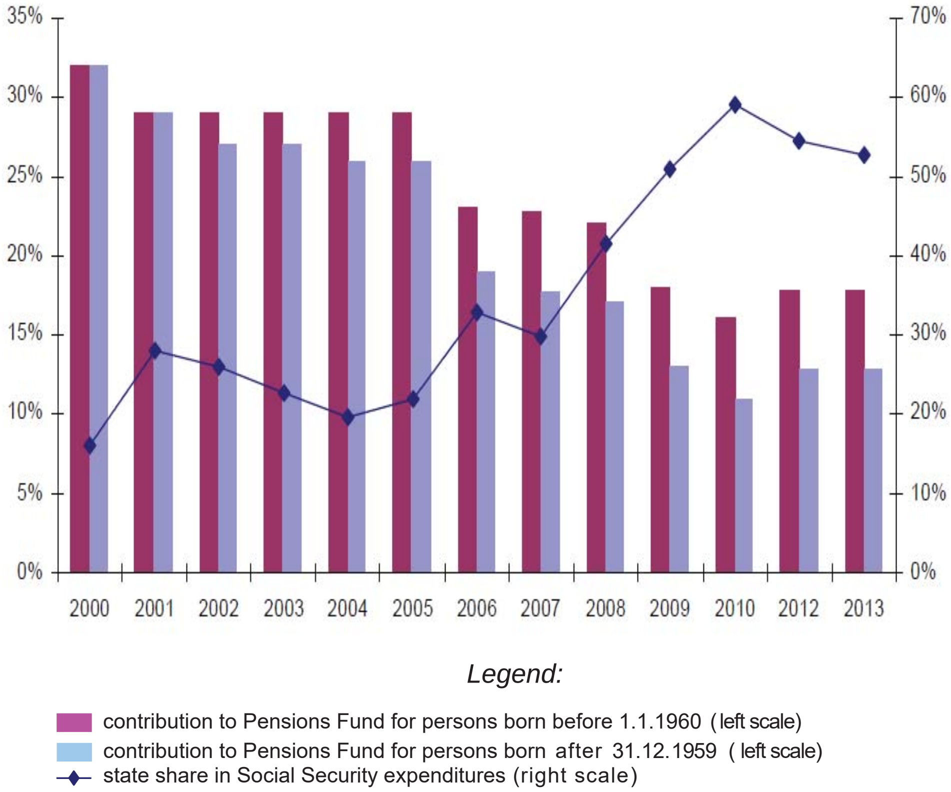
[2] Hristoskov, 2010, p. 299 (*in Bulgarian*).

Besides the decrease in the amount of pension contributions after 2000 the amount of pensions paid was increased and the coverage of the pension system was extended. This was coupled with higher subsidies for the insurance system from the State budget with most funds being paid directly into the pension system. In 2009, a part of the subsidy was "legalised" as a 12% State budget contribution to the sum total of the insurance revenue, whist the remaining part remains a subsidy proper. These developments have had a destabilizing effect on the pension system.

Figure 1 shows the reduction of contributions and increase in the share of the state budget in Social Security expenditures:

Figure 1

Contribution rates for the Pensions Fund and the state share in Social Security expenditures, 2000 – 2013



Source. Annual actuarial report 2012…

A growing rift has occurred between the decrease in pension insurance contributions and the sharp increase of pensions by the previous governments in power over the period in question. It can be reasonably argued that at the moment Bulgaria is receiving loans that enable it to continue to pay pensions. In the last few years the State budget deficit is lower than the deficit in the NII budget. We share the understanding that .... " much of the political decisions are temporary and lobbyist in nature, inconsistent with the stages of economic development".[3]

Had the NII addressed the problems relating to early retirement, disability pensions and the low retirement age, respectively dealt with the deficit issue, Bulgaria would have had a surplus of BGN 652 million in 2010 and BGN 1.711 billion in 2011. It makes no economic sense to continue paying pensions through government loans. In countries like Germany, for example, by law debt may only be issued for investment purposes and not for the payment of pensions.

The current government subsidy that makes up the total revenue of the pension system exceeds 50 percent. The government's share is primarily funded from tax revenues, which form approximately 90% of the State budget – more than two-thirds (73.13%)[4] represents the share of indirect taxes (VAT, excise and customs duties). The draft 2013 State Budget Act retains a very similar share of indirect tax revenues – 73.45 percent.[5] In other words, the first pillar is currently funded mainly from taxes and insurance contributions. This means that pensioners too contribute to the pension fund from which their pensions are paid.

The NII no longer enjoys a measure of relative independence and is being prepared for privatisation by the State. This will render it even more vulnerable to political influence and make pensioners dependent on decisions underlined by political expedience. This demonstrates that one of the major requirements for the pension system – its independence as the basis for predictability of the system over a relatively long period – has essentially been undermined.

2*. Pension system failings*: the adopted points-based retirement system has been roundly criticised. Its greatest failing is its inadequacy in terms of the choice of a retirement date. This can be overcome by abandoning the current system according to which the date of retirement is a sum total of absolute numbers (length of service in years and length of the period during which insurance contributions have been paid) and introducing an alternative, which relies on one of two criteria – reaching a certain age or actual length of the period during which insurance contributions have been paid, which will allow a retiree to receive a pension in a rate calculated on the basis of the points-based system.

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[3] Hristoskov et al., 2012, p. 194 (*in Bulgarian*).

[4] 2012 Bulgarian State Budget Act, State Gazette (SG) No 99 of 16 December 2011 (*in Bulgarian*).

[5] Draft 2013 Bulgarian State Budget…

3. The unnecessarily complex pension calculation system, which fails to take into account the income received by the insured, respectively insurance contributions paid and therefore contribution to the funding of the pension system, during their entire working life. This means that in all likelihood the calculated pension is not fully realistic.

4. Low rate of collection of insurance contributions. The introduced insurance thresholds partially boosted collection but failed to produce a major improvement. In 2010, the collection rate stood at 93.97% (or almost 94%) against 86.4% in 2009. Collected insurance revenue in 2010 was 6.03% lower (a shortfall of BGN 213,719.9 thousand) as compared to planned annual revenue.[6] The financial stability of the fund remains in jeopardy because the decisive factor for stability remains the accumulation and maintenance of a considerable reserve. There are still many companies, which hire workers and employees without an employment contract, i.e. don't pay any or pay social insurance at reduced rates.

5. In 2002 a possibility was created to receive a social pension for disability in addition to another pension. This prompted many retirees, particularly those of a more advanced age, to request medical certification and hence entitlement to that pension. The average number of social pensions for disability in 2010 was 492,243 and in 2009 it stood at 488,334, which represents an increase by 3,909 pensions. The average number of social pensions for disability in 2010 stood at 958,947 or slightly less than all pensions paid in Bulgaria.[7]

Second pillar of the pension system

the following organisational and managerial arrangements for mandatory pension insurance merit a positive appraisal:

- the underlying capital principle, which allows funds to accumulate into the individual accounts of future retirees but also increase the amount of the funds through investment. This will lower the burden for future generations for pensioners living at the same time. According to expectations the second pillar is to provide approximately 15-20% of income from work;
- the principle of legal and hence financial independence of pension companies and the additional mandatory pension funds (occupational and universal). By separating the activities of the companies and the funds the interests of the insured persons are safeguarded and guaranteed as a matter of priority;
- the sole object of the company is a pension insurance and a prohibition for the company to act as a lender. A requirement for obtaining a permit (license) for the company and obtaining a court registration for the funds; government

[6] Social insurance in Bulgaria in 2010…, p. 6.

[7] The total includes the pensions for disability due to general illness or occupational disease, social pensions for disability, civil and military pensions.

regulation through the Financial Supervision Commission (FSC) and representation of the interests of the insured through a Board of Trustees;

•a direct link between the amount of revenue received from additional mandatory pension insurance and insurance income paid and the income from their investment. This link and functional dependence between contributions and pensions is a personal incentive for the insured to proactively provide for their future;

•the insured person can choose whether to pay pension insurance into an occupation and/or a universal pension funds and the receipt of a pension in case of earlier retirement. Retirees are guaranteed the minimum profitability from the investments made by pension funds;

•the regulation of activities includes a set of rules on investing in certain instruments that are allowed to pension funds. The underlying objective is guaranteeing the savings of the insured and making a profit within the limits of a certain diversification of the investment portfolios of pension funds;

•the payment of the funds of insured persons into individual accounts, which are inviolable, and the possibility to receive in case of earlier retirement and the prohibition on the use of accumulated funds for any other purposes should be appraised as highly positive;

•the relatively well diversified insurance portfolios of the two funds;

At the same time certain failings in the system for additional mandatory pension insurance have stood out, which are summarised below:

1. Relatively low pensions largely owing to the low pension contributions, which over the greater part of the period was 3% of the insurance income. The rate has now been raised to 5%, which is still insufficient. From 1 January 2017 pension contributions paid into universal funds is set to increase by 2 percentage points, i.e. from 5% to 7%.

The average amount of the funds accumulated in an individual account with universal pension fund at the end of 2011 stood at BGN 1,123.41 and is highly insufficient to cover the percentage it will form of the future pension. Occupational pension funds are in a situation that is essentially the same. At the end of 2011, 247,333 persons were paying contributions to them and the net assets of the funds stood at BGN 471,129,000.[8] The average amount per insured accumulated with occupational pension funds stood at BGN 2,085.52. This coupled with the reasonable assumption that future retirees will be receiving pensions over longer periods of time, means that the sums in question are highly insufficient to cover the intended percentage of the future pension.

At present there are nine licensed pension insurance companies in Bulgaria. A breakdown of the average amount accumulated per individual in the different funds per gender and age is shown on Fig.2 and Fig.3:

[8]Tables No 1-P, 2-P and 5-P available at http://www.fsc.bg

Figure 2
The average amount of funds accumulated per insured with universal pension fund at 30.09.2012

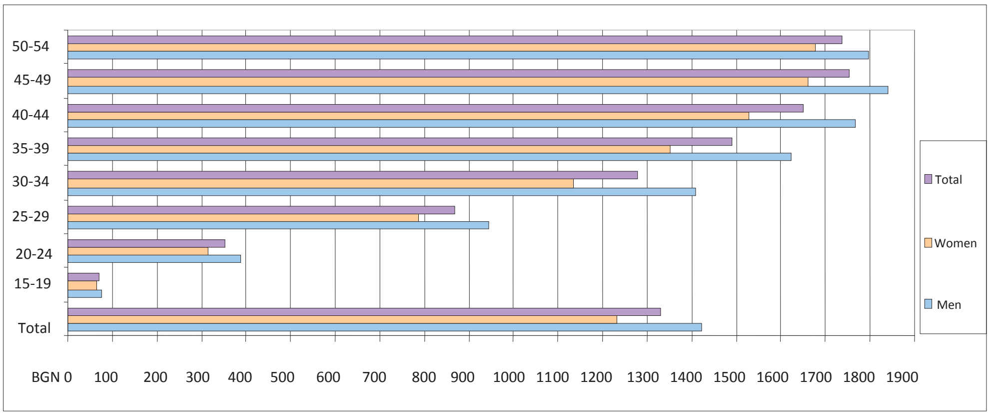
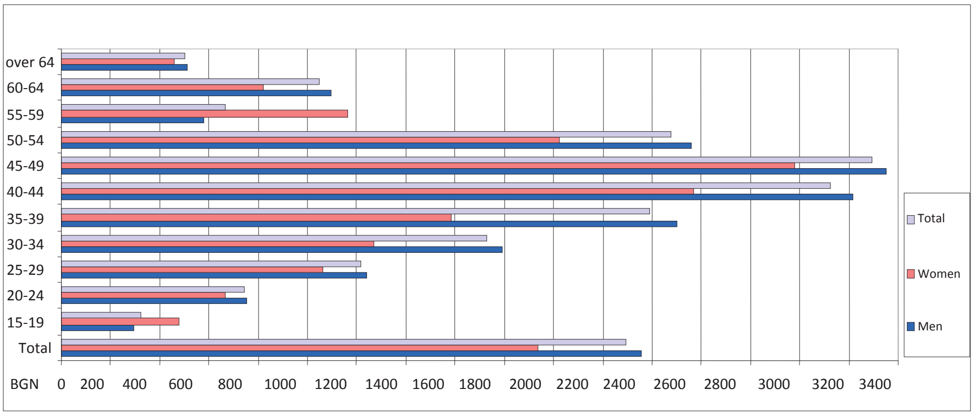


Figure 3
The average amount of funds accumulated per insured with occupational pension fund at 30.09.2012



It is easy to notice that the funds accumulated into the accounts of women who typically live longer are less than those accumulated into the accounts of men.

2. Insured persons were attracted without a comprehensive awareness and information campaign at a very high cost for the private companies.

3. On average, the insurance culture of the population is relatively low. This is due to the ineffective campaign aimed to attract them as clients of the pension insurance funds.

4. The underlying principles of the methodology for distribution of insured persons who had failed to choose a pension fund following the campaign was

incorrect and not in line with market principles. It would have made economic sense to deprive large companies of the possibility to insure persons on an ex officio basis for a certain period so allow smaller ones to reach parity. A similar arrangement was introduced in Poland.

5. The highly complex requirements for licensing pension funds remain a problem.

6. The State should provide support to the persons not covered by those subject to mandatory insurance. This group covers all individuals born before 31 December 1959 who do not pay contributions into a universal fund. This may be achieved through a subsidy from the State budget or another source.

Third pillar of the pension system – voluntary pension insurance

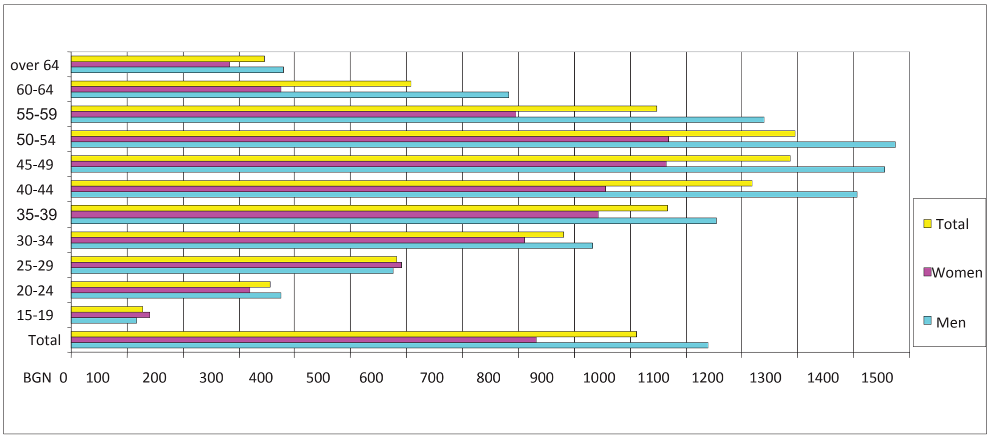
A summary of the results of the reform is set out below:

1. In the last 17 years 595,287 persons have been paying voluntary pension contributions. The net assets in these funds stand at BGN 564,724,000 and the average amount of funds accumulated per insured is BGN 948.66.[9] 5,078 persons pay voluntary pension contributions under occupational schemes with net assets of BGN 3,984,000 and an average amount of funds accumulated per person of BGN 784.56.[10] Only one pension scheme operates under this fund.

A breakdown of the average amount accumulated per individual in the different funds per gender and age is shown below.[11]

Figure 4

The average amount of funds accumulated per insured with voluntary pension fund at 30.09.2012



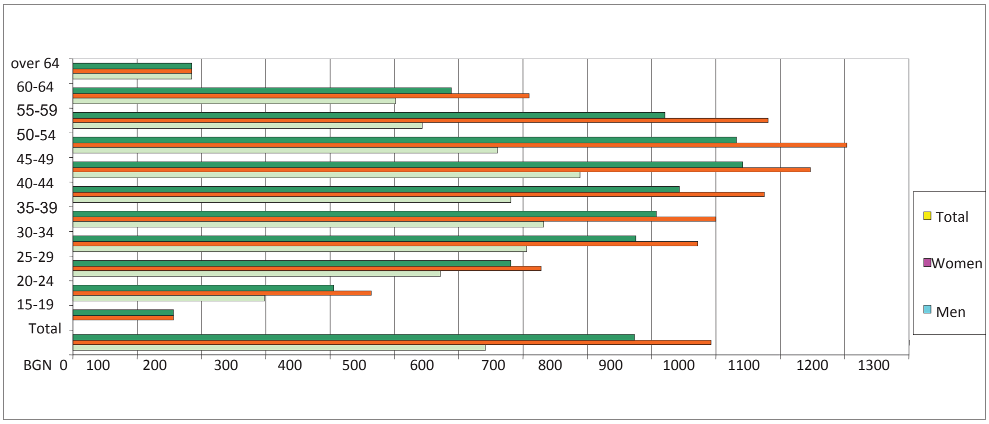
[9] Tables No 1-E, 2-E and 5-E available at http://www.fsc.bg

[10] Tables No 1-PS, 2-PS and 5-PS available at http://www.fsc.bg

[11] Financial Supervision Commission, Insurance Market…

Figure 5

The average amount of funds accumulated per insured with voluntary pension contributions under occupational schemes at 30.09.2012



The higher amount of funds accumulated in occupational schemes under the voluntary pension insurance fund is due to women being the majority of the workforce insured under the sole occupational scheme operating in the country (that of DSK Bank).

The results achieved are primarily due to existing tax incentives for the insurer and insured individuals. These incentives have been modified several times since the set up of additional voluntary pension insurance. Despite the incentives, however, the number of insured individuals shows a negligible growth rate.

2. The money accumulated in the individual accounts of future retirees in the different funds differ substantially. Under occupational schemes with voluntary pension insurance funds their total amount is BGN 4,975,000 as at 30 September 2012 or 0.83% of the net assets of the two funds. This significant difference in the amount of net assets can be explained by the fact that only one such pension scheme currently operates under one of the pension insurance companies – POK “DSK Rodina” AD.

3. Similar to additional mandatory pension insurance diversified investment portfolios have been set up for voluntary pension insurance under occupational schemes too.

4. One of the shortcomings of the existing system for additional voluntary pension insurance is the limitation by the employer of the right of the employee to use the funds accumulated in their individual account prior to the date of retirement.

There are both internal and external factors for the negative trends in the development of the pension system:

The internal ones are the product of domestic political, economic and demographic factors. The political factors are essentially underlined by a catastrophic failure to ensure consistency in the coordination of the revenue and expenditure policies on which the first pillar is built. None of the governments in power after 2000 dared take serious measures to ensure the stability and sustainable development of the pension system. A rift has emerged between the lowering of pension insurance contributions and the sharp increase of pensions by the previous government over the period in question. In fact, it will not be far from the truth to say that Bulgaria is currently borrowing in order to pay pensions. In the last few years the budget deficit is smaller than the deficit of the NII. In 2010, for example, the budget deficit stood at 3 684 billion BGN[12] whilst the amount of the budgetary subsidy it had received stood at 4 336 billion BGN.[13] The same happened in 2011 when the budget deficit stood at 2 160 billion BGN[14] whilst the budgetary subsidy for the NII stood at 3 871 billion BGN.[15]

The economic factors are the sources of public revenue, including the revenue of the insurance system. Prior to the economic crisis economic growth rates were high but the country remained one of the poorest in the European Union (EU). All governments elected used to compare themselves to previous governments and - to a modest degree - with specific average indicators for Europe and other countries. Some of the more important reasons for the low growth rates are low productivity; a dysfunctional (or rather corrupt) judiciary; and the absence of tangible incentives for the development of small and medium-sized businesses etc.

The demographic factors are essential for the sustainability of the system. There is a confluence of several factors, which undermine the stability of the current pension system – low birth rate, emigration of young people of working age and increasing life expectancy with a trend towards further increase in the future. The main factor for instability is the smaller relative share of the working population and an increase of the share of pensioners. It puts strong pressure on public finance and means a continued rise in public funds disbursed to finance the pension system. Some of these factors are also relevant to other EU Member States. Their aggregate impact is measured by an age dependency index (the ratio of working people to pensioners), which is expected to reach 2:1 in 2050 against an EU average of 4:1. The index was calculated immediately prior to Bulgaria and Romania joined the European Union. Bulgaria is in the fifth place globally in terms of ageing of its population. In the last few years 100 workers have supported between 82 and 85 pensioners. There is a high rate of illiteracy among the majority of the Roma and Turkish communities with a trend towards an increase of the relative share of illiteracy in the general population. The problem is aggravated by the percentage of unemployed persons, which further undermines the prospects for future stability of the pension system.

The external factors. The EU motto “Unity in Diversity” is emblematic for the choices Member States have, including in terms of their insurance systems. The Lisbon Strategy for the development of Community insurance systems, which brings the concept of active ageing to the fore, has a leading role. It requires Member States

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[12] Act amending and supplementing the 2010 State Budget of the Republic of Bulgaria…

[13] 2010 Budget of State Social Insurance…

[14] 2011 State Budget of the Republic of Bulgaria…

[15] 2011 Budget of State Social Insurance…

to keep in sight the quality of life of elderly people with a view to ensuring their full integration in social life. This inescapably pushes the pension system to the top of the agenda.

Perspectives for the role and significance of the Silver Fund as an instrument for stability of the pension system

In the *first place*, the role of the Silver Fund in the first pillar depends on the possibilities to overcome the deficit in this pillar of the insurance system. The possibilities are linked to the stability of the sources of funds and the dynamics that affect them. The investment of the accumulated funds and the pension system consolidation effect of that investment are also of key significance.

The proceeds into the Silver Fund originate from budget surpluses and this is money received mainly from the taxpayers. These funds are earmarked and are similar to general insurance contributions. The difference is that taxes are also paid by those who are not employed, including pensioners. This means that pensioners too are funding the insurance system. Budget surpluses are not always available. The possibilities to raise funds through privatisation are also relatively limited, which will put public finances under an even greater strain. Essentially, this is an unsustainable source of funds.

The assumption that the funds received from the privatisation of the enterprises built by the current pensioners would help close the gap in the budget of the public pension system proved untenable. Accumulated funds are insufficient. Being the poorest country in Europe, Bulgaria has many priorities that require multiple sources of funding. The country has the highest relative share of pensioners as a percentage of its population in the EU. Making smart and efficient use of EU funds is therefore vital. In the long run the possibilities to seek a new source of funds are also limited. In order to overcome the deficit the money accumulated in the fund alone must be in a position to ensure the payment of pensions over a period of at least three years. Given the current state the accumulated funds should stand at approximately 22 billion BGN. Instead their total amount is only 2.1 billion BGN. The nature and dynamics of the sources of funds paid into the Silver Fund warrant the conclusion that it may only act as a temporary buffer and that it does not provide a long-term solution to problem of addressing the efficiency of the public pension system.

Article 13(1) of the Law[16] sets out an exhaustive list of the types of assets and the percentage limits up to which funds may be invested. At the beginning of 2012 changes were proposed to the investment possibilities. Ideas were put forth to allow funds to be invested in local, Bulgarian instruments at national and community level. The rationale of the idea was (a) to diversify the portfolio; (b) boost the development of the monetary and capital markets in Bulgaria; and (c) create a possibility for partial repayment in 2013 of an issue of Bulgarian treasury bonds in the amount of 818.5 million EUR. The debates on the tabled proposal ultimately led to the abandonment of

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[16] State Fund Guaranteeing the Stability of the Pension System…

the initial idea of investing in Bulgarian instruments.[17] It was opposed by the European Central Bank, the Financial Supervision Commission, the Bulgarian National Bank and many economists. The opponents of the idea put forth the following arguments:

•The accumulated funds form a part of the fiscal reserve and their investment in Bulgarian treasury and/or municipal bonds would:

- destabilize the currency board and lower the country's credit rating in addition to jeopardizing the country's prospects for entry into the Eurozone (Milen Velchev, former Minister of Finance);

- result in the depletion of the funds, which will be tantamount to the "destruction" of the Fund (Plamen Oresharski, former Minister of Finance).

•Mean lower return from Bulgarian treasury bonds when the economy contracts and the need to finance the fund increases (Kaloyan Staykov, Market Economy Institute).

•Effectively be discriminatory vis-à-vis European securities because according to the draft law Bulgarian treasury bonds were not required to have a credit rating.

A careful analysis of the above arguments raises the following question: if the intended purpose of the Silver Fund is to act as a guarantee for a part of the fiscal reserve is it not presumed that the intended purpose of the fund concerned can be rapidly altered. And is the Ministry of Finance not attempting to achieve precisely this? Moreover, the funds have not been saved up by pensioners in the form of insurance contributions that have been expressly paid into the fund. If the answer to this question is yes, then what possible increase in future pensions are retirees, respectively the NII, expecting to receive?

The proponents of the idea to invest in Bulgarian treasury bonds put forth the following arguments:

•If the State does not invest how can it possibly expect foreign investors to do so?

•In other countries in which Silver Funds have been set up the money is invested in national treasury bonds (Simeon Dyankov, Minister of Finance). Practice shows that throughout the world Silver Funds invest in their own markets thereby propping up the national economies, including in times of crisis.

Regardless of how compelling the arguments put forth by each side, the discussion fails to take into consideration an important fact – the funds concerned are insufficient to have an overall stabilisation effect on the pension system. Furthermore, the BNB also operates at a profit a share of which is paid into the State budget. In 2010, the BNB transferred 210 million BGN.

In the *second place*, with respect to the principle and organisation of the fund, it should be noted that the intention of the lawmaker was that the Silver Fund would function on the basis of the principle of private accounts. This principle implies that funds will be accumulated over a relatively long period and invested for a profit. Private pension insurance functions along the same line. The only difference being that

[17] For more information see http://www.investor.bg/temi

insured persons do not have private accounts. This may cause a series of negative consequences for pensioners; making an unjustified decision on the redistribution of funds between them in line with the prevailing political environment[18] in favour of the current ruling party; the funds may be distributed in a manner conducive to a uniformity in the amount of pensions paid thereby ignoring the actual contributions made by each pensioner. Both scenarios will create tension amongst pensioners.

Efficiency can only be achieved if there is a direct link and proportionality between the funds transferred into and received by the insurance system. This requires not only a system that functions on a capital principle but one that operates on the basis of private accounts of each insured person, including a prohibition on the redistribution of accumulated funds between pensioners and, importantly, transparency in the management of the funds. These are the underlying principles of the second and third pillar, which offer a long-term solution and ensure that the insurance system functions efficiently.

In the *third place*, with respect to competition, no structures that effectively compete with that fund currently operate. A similar fund – the Fund Guaranteeing Bank Deposits – operates with assets, which as at 31 December 2011, stood at approximately 1325 million BGN.[19] The FGBD invests primarily in government bonds. There is no competition between the two funds and where this essential prerequisite is not present there is no drive for lowering the price of services offered or the overheads and operating costs of the Fund.

In the *fourth place*, the assets of the fund are managed by the State, which as a rule of thumb has a very low risk appetite. Typically, the decisions of the funds in which the State has a stake are made by managing boards composed of members who do not have specialist knowledge of finance and economy. Examples include the National Insurance Institute, the National Health Insurance Fund etc. The performance in terms of the profitability from the management of the assets of the fund to date is an obvious example that fully corroborates this conclusion. The function of the State should be to ensure transparency in the selection and appointment of competent managers and not taking on functions that are far removed from its domain of competence. The sound governance of such funds calls for fund managers and a managing company or an investment board.

The conducted analysis demonstrates the failure to follow a systematic approach in the organisation and management of the pension system. Reforms remain partial and inconsistent at best and serve to distort the wholesome course of its development.

This warrants the conclusion that from the perspective of the current state-of-play of the Silver Fund, it can only act as a temporary buffer and that it is not the long-term solution, ensuring the stability of the public pension system.

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[18] Such a populist decision was made by the government led by Prime Minister Stanishev (2005-2009) immediately prior to the end of his term in office – pensions were increased at the time when the country was beginning to feel the impact of the crisis and a new government was to be elected. An identical decision to raise pensions prior to the 2013 elections was made by the current government led by Boyko Borisov.

[19] Report on the financial performance of the Fund Guaranteeing Bank Deposits…

With regard to the specific insurance model, it should retain its present overall structure. The capital (private account) element as a component of the income of pensioners should be strengthened. Investments are nevertheless a must and there should be no obstacles to raising funds ourselves, including by active management of the money accumulated in the Silver Fund. Why should we continue boosting the liquidity of foreign economies? Perhaps because we consider unreservedly the risk associated with the economies of other countries lower. Yet, the current financial and economic crisis originated from the US, which was considered a virtually risk-free economy. Is there such a thing as a risk-free country and economy in the first place? Practice shows that the answer is no. Yet practice also shows that there are alternative approaches and possibilities to mitigate risk. From this point of view the calls for full privatisation of social insurance are untenable. Chile is a case in point with results that are controversial.

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