

Ján Oravec

The Story of the
Creation
of Personal
Retirement
Accounts
in Slovakia



Nadácia
F. A. Hayeka

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„The ultimate lesson is that the only revolutions that are successful are those that trust the individual and that wonders that individuals can do when they are free.“

José Piñera

*(„Empowering Workers:
The privatisation of Social
Security in Chile, 1995“)*

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QUICK FACTS ABOUT THE PROCESS OF THE SLOVAK PENSION REFORM

June 10, 2002: The F. A. Hayek Foundation organizes the first international conference on the need of pension reform in Slovakia. Jose Pinera is invited and delivers an inspiring presentation about the new pension paradigm of personal retirement accounts. Many politicians are present because of the upcoming elections, including Ludovit Kanik, at that time a leader of Democratic Party, and later Labour Minister implementing personal accounts.

September 25-26, 2002: Parliamentary elections give reform oriented parties an opportunity to form a new government again

November 4, 2002: The new government adopts a declaration committing itself to personal retirement account

2003-2004: Necessary legislative framework is prepared, parliamentary delegation visits Chile, and law is approved.

November 1, 2004: The newly-established pension companies start their advertising campaigns to attract Slovak workers to the new fully-funded pillar of the Slovak pension system.

January 1, 2005: The first day of the pension reform, a period of 18 months giving Slovak citizens opportunity to opt for personal retirement accounts.

QUICK FACTS ABOUT THE FIRST RESULTS

June 15, 2005: the first billion of Slovak crowns of personal savings is accumulated at individual accounts.

August 15, 2005: 1 million citizens opt for the personal savings accounts.

February 1, 2006: SKK 10 bln. of pension savings accumulated at individual accounts.

May 18, 2006: accumulated private pension savings exceed 1 % of GDP.

June 30, 2006: 1.53 million, or some 70 % of eligible citizens, join the new system in its first 18 months and accumulate SKK 17.3 billion at their private pension savings accounts.

I. Introduction

The story of creation of personal retirement accounts in Slovakia cannot be told simply by presenting plain facts, irrespective how impressive the quick facts above are. There are two major reasons for that. Firstly, the pension reform itself, otherwise unprecedented achievement needs to be put within a more general framework of a country making from the beginning of 90-es a very difficult economic, social, and political transition from centrally planned economy ruled by communist totalitarian state towards democratic society and market economy. Secondly, one can not get a full picture without personal stories of many individuals whose personal views, thoughts, visions, attitudes, and decisions were of crucial importance in terms of their impact on an overall result.

These two observations are fully projected into following personal reflections upon the story of creating the personal retirement accounts in Slovakia. Firstly, the text is divided into three time periods, each having identified its own specific challenges and strategies to meet them.

1990-1998 was a period of intense and far reaching overall political, economic and social changes, however, waters of pension reform were flowing very slowly, almost stagnating in meanders of a state run system inherited from communist times.

In 1998-2002 there were the first signs of increased public awareness of a pension time bomb ticking also in Slovakia, with the first – far from being ideal - reform proposals elaborated by the government in the end of this period.

Last, but not least, in 2002-2006 there was probably a new “world record” set up by a preparation and implementation of the Slovak pension reform with individually owned personal retirement accounts just in 30 months. Secondly, throughout the text covering various periods a role of individuals will be constantly underlined. It is exactly dedicated individuals who can make the difference. Of course, these individuals also need to have other conditions working in their favour in place: favourable political development, politicians who are willing and ready to implement the reform, meeting the right people at the right time, interest and positive attitudes of crucial media, etc. The story of the Slovak pension reform is almost a textbook illustration of coincidence of all these conditions for success.

Finally, these reflections are written also as a tribute paid to Jose Pinera for his contribution to the introduction of individually owned personal retirement accounts in Slovakia. Jose is a man who has not only pioneered the first comprehensive dissolution of a Bismarckian type of a welfare state in the 20th century. In addition, he is making enormous efforts to expand an important idea of individual liberty by

ever expanding a list of “pension reform countries” following an example he set up 25 years ago.

II. 1990-1998: Stone Age of Cosmetic Changes in State Pension System

- **Major Problem of the Period:** Pension “time bomb” in shadows of other urgent problems of Slovakia being busy by making transition from its centrally planned economy to market economy and becoming a newly established independent state.
- **My strategy:** to conduct research and increase public awareness via lectures and presentations.

The Very First Years of Transition

A collapse of communism in November 1989¹ Velvet Revolution opened a window of opportunity for implementation of far-reaching reforms. In order to understand why a pension reform – the mother of all reforms - was implemented only after 15 years of transition, we need to go back to the beginning of the transition process itself.

1 At that time Slovakia was a part of Czechoslovakia, a compound state – federation of two nations, Slovaks and Czechs, living together since 1918.

In 1989, the Slovak economy was the economy with one of the highest shares of state ownership in the economy in the world², the most of the Slovak exports were directed to non-competitive markets of former communist countries, and back in 1989 the Slovak economy was dominated by several large companies quickly losing their competitiveness, suffering a massive over-employment reaching tens of thousands people. The whole economy and society was in urgent need of fundamental structural adjustments.

As a result in the beginning of 1990 there were many urgent challenges to cope with:

- transition from a totalitarian Communist regime to a multiparty democracy,
- transition from a centrally planned economy to a market economy,
- transition from state paternalism to individual responsibility.

Facing just one of these challenges would be more than enough for one generation. That is why I sometimes call this period *"One Century Compressed Into One Decade"*³. Discussions about privatisation and restructuring of state owned companies, market opening and liberalisation,

2 It was about 98 % of GDP.

3 Ján Oravec: "THE TRANSITION OF SLOVAKIA: One Century Compressed Into One Decade", Economic Freedom Network Annual Meeting, Bratislava, October 16, 2003.

including deregulation of politically sensitive prices⁴ were on a top of political agenda of that time.

In the end of 80-ies I was working as a young research assistant at the Institute of Economics of the Slovak Academy of Sciences. It was exceptional and exciting time when everybody wanted to contribute to necessary changes. I was no exception. Since free market thinking was extremely scarce good at that time, I was looking for the most efficient way how to accelerate our transformation towards free market and free society.

The first step was to facilitate association of like-minded individuals and that was why – together with my colleague Ivan Svejna – we established The Libertarian Club in the beginning of 90-ies. After several months we felt we still need to take further steps in order to increase our impact. And we invited other market oriented people⁵ to establish an economic think tank called The F. A. Hayek Foundation⁶ in 1992. Its main mission was to establish a tradition of free market thinking and free market policies that were

4 Gas, electricity, heat, rents, etc.

5 Including Jozef Kucerak, the prime minister of the first reform oriented Slovak government after November 1989, Ivan Miklos, at that time the minister of privatization in the same government, and many recognized economic journalists, or other well-known people.

6 At that time Hayek was perceived by us as one of the most persuasive symbols of free market thinking of 20th century.

virtually absent in Slovakia before November 1989. Later on, another Slovak reformer known for pushing through the 19-% flat tax – Ivan Miklos, and others went their own way and they established their own economic think tank called MESA 10.

In the meantime, history was making its giant steps almost every day. Due to differences in its industrial structures⁷ Slovakia was disproportionately hit by the first reform measures⁸. Growing disagreements between Slovaks and Czechs over structural reforms, and monetary and fiscal policy mix resulted into a well-known „velvet divorce“ of the Czecho-Slovak federation and its split into two internationally recognised entities as of January 1, 1993. As a result, in addition to the above-mentioned three parallel historical and non-precedent transitions Slovakia was forced to face the fourth difficult process, a transition from a federation to an independent state.

Pension System in Shadows

Only by recognising of all these specific features of this period one can understand why pension reform was not a top priority of those days. We all were aware of importance of ageing challenge from the very beginning,

7 Dominated by heavy industry.

8 For example, while unemployment rates in the beginning of 90-ies were steadily below 2 % in the Czech Republic, they exceeded 10 % in Slovakia.

however, at the same time we were simply completely consumed and busy by debating and solving all other urgent issues associated with privatisation, restructuring, price deregulation, trade liberalisation, etc.

With more and more years coming by and transition experience accumulated I started to understand that of the above mentioned four historical challenges, there is the transition from state paternalism to individual responsibility that is by far the most difficult transition of all. After 40 years of communism people still believed that it is up to the state to take care of them in their retirement, to finance, administer, provide, and safeguard their pension benefits. An institutional framework and main features of the pension system of that time looked accordingly.

The Slovak welfare state in the first half of 90-ies was still a centralised state system taking care of the individual from the cradle to the grave. It was compulsory pay-as-you-go system with universal coverage and defined benefits that were financed from payroll tax. It was complicated⁹, conditions of eligibility were not transparent, benefits were automatic claims, the system was extensive, expensive, and open to abuse. The first changes introduced into the pension system were just reactions to urgent transition problems. For example, as of March 1, 1991 a pension indexation was introduced to protect pensioners against high inflation rates that resulted from price liberalization.

9 With 80 different kind of benefits.

However, the originally centralised state system did not manage to stay immune against certain reform efforts to decentralise it. It was important that financing of the welfare state services was separated from the state budget. In 1993 the National Insurance Company was established to take care of sickness, pension and health insurance, and different kind of benefits. In 1994 this state social security provider was transformed to a public tripartite institution¹⁰, and renamed to the Social Insurance Agency¹¹.

Later, in 1996, there were voluntary and non-universal occupational schemes introduced as employer-employee schemes managed by pension insurance companies¹² and state was defining rules of the game and supervision. There were also other partial changes implemented, for example, as of January 1, 1994 preferential treatments of different working categories were abolished.

1994 was also an important year because The World Bank published its famous report¹³ that presented the first comprehensive and global examination of old age security.

10 With representatives of the government, labor unions, and employers being present in its board.

11 Taking care of sickness and pension insurance + accident insurance, reduced number of benefits payments.

12 With 100 000 clients minimum requirement.

13 Averting the Old Age Crisis, The World Bank, Washington, 1994.

This report suggested for the first time three systems since that time becoming well-known as “three pillar” architecture of the reformed pension system:

- a publicly managed system with mandatory participation and the limited goal of reducing poverty among the old
- a privately managed mandatory savings system
- a voluntary savings system

The report concluded that *“a combination of different income security policies is more effective than any single approach”*.

I read this report, and from the beginning I had difficulties accepting this proposal. As for a „freedom fighter“ it was unacceptable for me to accept the idea that the transition from state paternalism to individual responsibility would end up in a semi-paternalistic system where individual freedoms and responsibilities would be limited by obligatory requirements of the government, although I understood the complete transition would still be a very long way to go.

Despite these my disagreements with major conclusions and proposed three pillar architecture, the analytical aspects of the report increased even further my attention I paid to these issues. Since that time I was giving even more lectures and public speeches aimed at urgency of the pension crisis, lack of public awareness of these problems, including politicians, policy-makers, and major media,

necessity to take immediate actions to revert unfavourable trend.

As reported extensively by economic weekly TREND at the Slovak Economic Forum Meeting on transformation of social system in Slovakia organized by MESA 10 I criticized paternalistic features of prevailing approaches of policy makers of that time *"In presented alternative to Labor Ministry's reform concept, Jan Oravec started with the criticism of the myth of moral superiority of state funded pension schemes. He pointed out that funded financing is preferred over PAYGO, and market forces in social sphere are preferred over political mechanisms"*¹⁴. While contradicting views presented by the representatives of Labor Ministry, I presented for the first time alternative arrangements of the pension system based primarily on private savings.¹⁵ In my papers, analyses¹⁶ and presentations I focused on global trends towards pension system reforms and a lack of attention in Slovakia, underlying following foreign inspirations for different pension scheme reform strategies: 1. Singapore - centralised system of mandatory personal savings administered by state, 2. Chile - decentralised system of

14 Trend, May 15, 1996, 8A-9A

15 Jan Oravec, Reform of pension scheme in Slovakia, 1996

16 E.g. J. Oravec: Analysis of Various Welfare State Systems, Bratislava, 1997, written for The Institute of Liberal Studies Bratislava.

mandatory personal savings managed by private pension funds.

And I thought that these inspirations could be applied into the Slovak pension scheme by choosing one of the following reform strategies: 1. introducing mandatory personal savings accounts at existing Social Insurance Institution¹⁷, or 2. introducing mandatory personal savings accounts and decentralising their administration to either a) existing commercial life insurance companies, or b) newly created specialised institutions (pension funds)¹⁸. My strong preference was from the very beginning for Chilean model. Again, I saw a mandatory aspect of these reform scenarios only as an intermediary step towards the system based on voluntary pension savings of individual citizens and with absence of any state paternalism.

In addition to a campaigning in Slovakia I was making presentations on these issues abroad, including following two ones: on November 12, 1996 I made a presentation of the social security system in Slovakia in Warsaw, Poland at an event that was organized by the Polish Chamber of Commerce, on December 11, 1997 at a workshop *“Pension Reforms in Eastern Europe”* in Ljubljana Slovenia I made a presentation of a paper called *“Pension Scheme in Slovakia and Relevance of World-Wide Pension Scheme Reform Efforts to Slovakia”*.

17 “Singapore model”

18 “Chilean model”

III. 1998-2002: Increased Public Awareness, the First Reform Efforts

- **Major Problem of the Period:** a pension crisis finally identified as a major problem, the pension reform becoming a top priority of the government, however, the wrong solutions elaborated as a result of a leftist politician becoming a Labour Minister
- **My strategy:** to fight against approval of the wrong solutions proposed by the Labour Ministry

1998 was a very important year for acceleration of pension reform efforts as well as for whole Slovakia. In 1993-1998 period the Slovak governments were implementing mostly bad, mistaken, and irresponsible policies. Originally intended concept of a voucher privatisation was replaced by direct sales of state property to known buyers¹⁹ with all negative consequences: non-transparency, corruption, growing interlinks between political and business elites. Certain sectors and companies were excluded from privatisation²⁰, politically sensitive prices were not deregulated and companies producing these commodities and services experienced serious financial troubles. Restrictive fiscal policy was replaced by

19 Mostly by friends, families, loyal people.

20 Including banking, telecom, energy sectors.

expansionary fiscal policy²¹ with growing budget deficits, and government debt, government borrowing was crowding out private investments²². Since foreign capital was discouraged the Slovak economy was seriously undercapitalised. Legislative framework was more and more distorted by vested interests²³ Slovakia was excluded from integration efforts²⁴ of other transition countries.

As a result of all these measures and their negative results there was almost universal consensus among experts as well as general public that country is heading in a wrong direction. The major slogan of a political opposition was embodied into one single word: CHANGE. Even though in 1998 parliamentary elections were won by HZDS, a party of Mr. Meciar, a prime minister with authoritarian tendencies, its coalition potential was close to zero. As a result of this the opposition parties, three right wing parties and one left wing party, were able to form a new government which dedicated its future program towards reversal of all elements of previously bad policies.

21 With public expenditures aimed at large public infrastructure investments.

22 At some point government bonds interest rates exceeded 30 % when there was one digit inflation.

23 Government policies were increasingly favoring some and discriminating against others.

24 EU, NATO, OECD.

The new government after 1998 accelerated privatisation and widely used a method of open international tenders, banking, telecommunications, energy sectors were restructured and privatised by foreign investors. Politically sensitive prices were deregulated and regulatory framework was reformed, more isolated from political influence by establishing of independent regulatory authorities. Large public infrastructure investments were slowed-down, intentions to reform public sector declared, and as a result of more responsible fiscal policies government bonds interest rates were reduced significantly. Foreign capital was attracted by (first) tax holidays, and (more importantly) by efforts to improve business environment, legislation was liberalised in many areas and sectors in order to comply with international standards. Finally, integration efforts were accelerated and Slovakia joined OECD in December 2000, and had realistic prospects for becoming EU and NATO member.²⁵

In the beginning of this period it was clear to our team in the Hayek Foundation that 1998-2002 period did represent a window of opportunity for implementation of many ideas we were promoting by our activities, including tax and pension reforms. Since the foundation was established we were consistently practising our “*think tank – do tank*” approach. We were not only promoting reform

25 Slovakia actually became a member of NATO and EU in 2004.

ideas and encouraging public debate on various issues, we were always also lobbying for their implementation trying to persuade politicians, policy-makers, law-makers, and opinion-makers that by contributing to their implementation they would encourage prosperity in our country.

In order to help to accelerate much delayed structural reforms in Slovakia we made a strategic decision back in 1999 that I would accept a position of a Chief of Strategy at a Ministry of Economy. I was going there with a vision of a role of the ministry to be changed fundamentally and to make its transition from being the ministry that was conducting old fashioned industrial, energy, and trade policies based on strong sectoral focus²⁶ to the modern ministry with modern policies focused on improvements of business environment in Slovakia.

The most of my activities were focused on corporate sector reforms that were badly needed for an increase of competitiveness of the Slovak economy. It was crystal clear to me that it could not be done without significant improvements of business environment, especially its legislative, regulatory, and administrative framework. In cooperation with FIAS experts²⁷ my team prepared a strategy paper on elimination of legislative, regulatory, and

26 Picking winners, selecting sectors and companies to be promoted by the government.

27 Advisory agency being a member of the World Bank group.

administrative barriers for doing business in Slovakia, including a list of detailed proposals and measures how to improve the business environment in a defined period of time. This paper was highly welcomed and appreciated by domestic experts and Slovak as well as foreign businesses as a foundation of pro-business government policies in upcoming months and years.

Tax system is without any doubt one of the most crucial elements of the business environment. The Hayek Foundation started its own campaign for reduction of a total tax burden in Slovakia and for implementation of a flat tax idea back in 1996. In this year we established *The Slovak Taxpayers Association* that later launched its very successful project of a calculation and publishing of the so called *Tax Freedom Day*. It increased a public awareness of a close connection between high government expenditures and low net wages, including worsened prospects for prosperous economy. Being in an executive position I brought this fight into internal structures of the government. In one of the documents elaborated by my team and submitted to government for approval there was an introduction of a flat tax of 20 per cent (still back in 1999/2000!) proposed as one of potentially the most powerful measures to make the business environment more favourable for both domestic and foreign businesses. Since at that time the lady minister of finance, Mrs. Schmognerova, was a representative of the left wing party, our proposal failed. However, the first seeds were planted, and this venture brought its fruits several years

later when the comprehensive flat tax proposal was implemented as of January 1, 2004. In my view this story proves that my life long strategy of deliberately „*setting outside bars*“, or „*going beyond what is possible in a given time*“ works and sooner or later pays off.

However, I was busy not only by working on laying down the foundations for the corporate sector reforms, a preparation of a restructuring of utilities and their privatisation, or improvements of business environment by eliminating various barriers, and a proposing the flat tax reform. Thanks to my decision to join executive power²⁸ the Hayek Foundation was able to influence directly also crucial decisions that were important for the pension reform as well: 1. to accelerate and help to approve in the government and parliament the biggest privatization in Slovakia ever²⁹, 2. to persuade the government to allocate the most of privatisation revenues for financing of the fundamental pension reform in future³⁰, 3. to help to

28 Although my original expectations differed significantly from reality: I expected to complete my mission within a period of 3 months, and finally stayed there for more than 3.5 year.

29 The Slovak Gas Industry, the company transiting a Russian gas from Russia to Western Europe.

30 SKK 65 bln. of SKK 130 bln. from selling of a 49 % stake in the company were deposited by the government at central bank with an aim to use it after the introduction of the pension reform to finance an early stage of transition period. These revenues were expected to last for up to six years.

refuse the wrong pension reform proposals of the Labour Ministry by the government by the end of 1998-2002 period.

Unlike in other policy areas there were no major changes proposed or debated in the area of the pension reform. And it was not because the problems would not be visible. With a growing number of analyses published it was more and more clear that the fundamental changes were necessary. Contribution rates necessary to keep 1996 gross average wage/average pension rate were predicted to grow from 27.5 % in 1996 to 48.6 % in 2040. Despite a comparatively very low effective pension age³¹ there were no efforts to increase it. Even a scenario with modestly increased pension age³² the system would end up in significant deficit in 2040. There were calculations made that if demographic trends were to remain unchanged, in 2040 there would be receivers of benefits outnumbering the contributors. In other words, each worker would have to pay contributions to cover old-age benefits of more than one pensioner.

Why there was – despite of all this persuasive evidence – almost no reaction of the responsible ministry? The answer is simple. Like in a case of the Finance Ministry, there was the Labour Minister Magvasi who was

31 59 for men and 54 for women.

32 +1 year for men and +3 years for women in period 2002 – 2014.

representing the left wing party. And he thought that the best way how to implement ideological principles of his party in his area of responsibility would be to pretend that there was still no sense of urgency, no need to change pension age, no need to change the pay-as-you-go financing. As a result of that there was no incentive to look for alternative solutions. Even in a case that some solutions were mentioned unofficially, funded – capitalisation - schemes played no or only a minor role in them.

After two wasted years in the second half of 1998-2002, Mr. Magvasi finally prepared his proposal of the reform. However, it could hardly be called the reform, because what he came up with, if implemented, would be perhaps worse than no reform status quo. His proposal consisted of a creation of personal retirement accounts that would not be privately owned, and would be administered centrally by the public Social insurance company, and managed by investment committee members of which would be nominated by the government. Simply a nightmare!

When this proposal was submitted for inter-ministerial comments, I put much efforts, time, and energy into voicing the strongest possible disagreement of the Ministry of Economy with this particular solution. I remember I called it *“the manifest of collectivism”* during one of our meetings aimed at a settling of the dispute between the two ministries.

Mr. Magvasi and his party were trying their best to get the approval for this proposal from the government. We needed to use a strategy of combination of generating of both internal and external pressure on the minister and his ministry to force them to change their anti-reform attitudes. Even though the minister was using his political backing to defend his positions, he finally surrendered also due to a growing pressure from Ivan Miklos³³ and his team. Fortunately, it was only several months prior to 2002 election when the government decided that this particular proposal would not be even submitted to the government and did leave the decision on the pension reform for a future government.

We have learned our lessons from this dangerous situation of being quite close to an implementation of a perverse pension reform. It was exactly this situation that forced us in the Hayek Foundation to make our next important and strategic decision that brought us further towards increased involvement in the pension reform “crusade”: to prepare our own ambitious proposal of the pension reform, and to find potential allies abroad that would help us to fight with ideas efficiently for the reform.

33 Miklos held in 1998-2002 a position of a Vice-Prime Minister for economic affairs, and enjoyed a strong position within the government being a close ally of the prime minister Dzurinda.

It was in this period of 2000-2001 when I contacted Jose Pinera for the first time. I did not know him personally. I read about his achievements in Chile and on Internet I got his e-mail at his "*International Center for Pension Reform*"³⁴. My intention was to get in touch with him and discuss the idea of his potential visit in Slovakia. I remember I expected to hear from him something like this: *I am busy, my diary is full, and anyway I charge a speaking honorarium of XY tens of thousand bucks.* Instead he replied immediately: *Yes, I can come. My conditions: I do not take any money, when you invite me, I expect you to cover a business class air ticket from Santiago, a nice hotel and several cappuccinos in Bratislava. That is all. Oh no, still one more thing: because there are 200 countries in the world, I would come to Slovakia only in a case there would be a realistic prospects that my presence there could help to make the LAST push for the reform.* It was decided. We started to do our homework.

34 Its website is as follows: www.pensionreform.org

IV. 2002-2006: Probably a New World Record: The Pension Reform Prepared and Implemented in 30 Months

- **Major Problem of the Period:** After previous periods of efforts aimed at increased awareness, periods of fights against the wrong solutions, the major challenge of 2002-2006 became: 1. a preparation of a sound reform proposal, and 2. its implementation.
- **My strategy:** 1. to fill a gap and to come up with our own proposal, 2. to attract attention of politicians by inviting Jose Pinera, 3. if the reform would receive “a green light”, the NFAH team was ready to help with implementation of the reform

In 2002 several Ponzi schemes collapsed in Slovakia following the same patterns as everywhere: firstly, doubtful investment companies - so called “nonbanks” - collecting money from population successfully by promising high rates of return, secondly, being unable to keep their promises, thirdly, declaring bankruptcy. There were numerous scandals and heated debates about it. I thought that in order to underline the urgency of the reform it was good timing and opportunity to write and publish an article

called *"Another pyramid scheme"*³⁵ where I pointed out that the Slovak pension system has several features of the pyramid scheme.

We started to work on our own pension reform proposal and on a preparation of Jose's visit almost immediately after email exchange with Jose. There were regular parliamentary elections called for September 25-26, 2002. We adjusted all our preparatory works towards this date. We have chosen June 2002 as the most appropriate timing for both the presentation of our own proposal and for the visit of Jose Pinera. Our team started necessary analytical works, with Martin Thomay³⁶ working on the proposal full-time. At the same time an intense communication with Jose started in order to maximize results of his presence in Slovakia. Finally, we came to our mutual agreement that we will prepare a four-day visit of Jose in Slovakia. The date was set up for June 8-12, 2002. The program of the visit included the Annual lecture of the F. A. Hayek Foundation, the international conference on pension reforms organized by the Foundation, presentation of its reform proposal during this conference, presentation of Jose, his TV appearances, meetings with politicians, etc.

35 Jan Oravec, *Another Pyramid Scheme*, Domino Forum, number 10, 2002, p.7

36 At that time working with The Hayek Foundation, later leaving us with an ambition to establish his own venture.

After Jose's arrival we started his visit with informal dinner in Bratislava Old Town with the Hayek Foundation team. We agreed that before an official part of the program Ivan Svejna would bring him to his hometown Banska Stiavnica, the UNESCO site, to see also other parts of Slovakia than Bratislava.

The next day they together visited Banska Stiavnica, an old mining town and picturesque place about two hours by car from Bratislava. Ivan prepared a small picnic there for closest friends. Among them there was Ludovit Kanik, a friend of Ivan, and at the same time a leader of small right wing value based party, called Democratic Party that was preparing its election campaign for upcoming elections.

During informal discussions Jose strongly suggested to Ludovit Kanik to put a high priority in its agenda on the pension reform, to campaign with it, and even becoming a Labour Minister after elections with a vision of introduction of personal retirement pension accounts. Even it seemed to be more like utopia at that time, Jose's words proved to be almost a self-fulfilling prophecy because Kanik after elections in fact became the Labour Minister and did implement the pension reform...But it was still several months to go.

The next immediate important event for us was the Annual Lecture of the F. A. Hayek Foundation on June 10, 2002. In my opening speech I introduced Jose as the famous architect of the successful and the most well-known

pension reform in the world. I underlined that as any important and pioneering reform it has its own supporters and opponents. Most of these debates were available to us. However, it is much better to hear directly once rather than to read ten times the second-hand information. And I gave the floor to Jose. Since I never had the opportunity to listen to Jose lecturing, his presentation was a big surprise for everybody in the conference hall, including myself!

Jose in his lecture showed his best performance, making enthusiastic, eye-opening speech, presenting his famous small pension book, and warning politicians to avoid measures that would hurt pensioners “do not touch grandmother’s money”. And he was repeating it again and again the next day during the conference, in his interviews with press, in his TV and radio interviews, and during a press conference.

After Jose’s return to Santiago I thanked him in my e-mail of June 26, 2002: *I want to thank you for everything what you did in Slovakia to support a pension reform here. From responses of direct participants and from media coverage of your visit it is clear that people here were really deeply impressed by your presentations, interviews, arguments and above all by SIMPLE language you used to talk about these issues.*

I must confess that personally you have surprised even me. Of course, I was looking forward to meet you as a personality that is well-known all over the world. However,

*I was expecting to meet someone who is "a former :-)
reformer", who is making his living from his past
performance. I found that in fact you are perfect opposite
of that. I found a man who is seeing the world as a
continuous opportunity to look for improvements of our
lives, to identify them, to prepare an action plan and to
execute it successfully. And Jose replied by quoting what
Ronald Reagan used to say, "You have seen nothing yet".*

Our conference on pension reform was attended by the specialists and experts from insurance companies, pension funds as well as general public. During this conference we introduced our own proposal of pension reform in Slovakia. Of four types of pension reforms, the parametric changes, notional accounts, multi-pillar models and full privatization of social security, we presented our strong preference for the full privatization. In the long term our proposal would mean an elimination of the current PAYGO system by a system of voluntary savings, without any mandatory aspects. Minimum subsistence level would be guaranteed by arrangements outside the pension system itself.

Again, with my deliberate strategy of "going beyond possible", we went for this radical proposal as a point of departure, knowing that politicians that were present at the conference were ready to "digest" only certain parts of it. The more radical the original proposal was, the more likely the final compromise would be acceptable also for us.

As a result media were able to report about three proposals: first, the Labor Ministry's proposal, the Ministry of Economy's proposal and the most fundamental and far reaching proposal that was presented by the Hayek Foundation ³⁷.

September 25-26, 2002 elections were won by Mr. Meciar and his party again. The situation after 1998 elections repeated itself also after 2002 elections. Because of a low coalition potential of Mr. Meciar, in October 2002 three right wing parties of then government coalition were able to form a new government, which was even more reform oriented as previous one because it was joined by a newly established right wing party.

A window of opportunity for the 2nd wave of fundamental reforms putting Slovakia ahead of other transition countries was opened after October 2002, including labour market reform, flat tax reform, further reforms of business environment, school system reform, health care reform, fiscal decentralisation reform, and, of course, the pension reform. Ivan Miklos, the deputy prime minister and finance minister of the Slovak Republic in the second government of Mikulas Dzurinda, could report in his article in the Wall Street Journal encouraging news also what concerns the pension reform: *"We are preparing*

37 There are three proposals of the pension reform, SME daily, July 12, 2002, p.7.

*pension reform to transfer the current pay-as-you-go system to a program of real savings in personal accounts.*³⁸

When this unique window of opportunity for implementation of ambitious pension reform was opened, we have made another important strategic decision. After my 1999-2002 mission at the Ministry of Economy, we deliberately opted for think tank becoming do tank again. We decided to send our expert team to help Ludovit Kanik as the responsible minister and his ministry to implement the pension reform we have been long time campaigning for. The F. A. Hayek Foundation expert team, including Ivan Svejna, Martin Chren, and Martin Thomay became an important part of the pension reform team at the Ministry of Labor and Social Affairs during years 2002 – 2003, with Ivan Svejna becoming a Director General of the Ministry and a Head of the team responsible for a preparation of a reform strategy. Later on Ivan and Martin Chren wrote a book *“Pension Reform: The Slovak Way”* describing their experience from this period.³⁹

Our previous close contacts with the world best reformers proved to be of crucial importance for the whole reform. It was natural that Ivan Svejna in his new position

38 Ivan Miklos: A Flat Tax and More, May 8, 2003 , Wall Street Journal.

39 The book was called “Dôchodková reforma po Slovensky” and was published in Slovak in 2004. It is also available on web pages of The F. A. Hayek Foundation, www.hayek.sk.

invited – following a suggestion from Jose Pinera – two experienced Chilean advisors, Augusto Iglesias, and Klaus Schmidt-Hebel. They joined the team and without their important contribution it is difficult to imagine that final overall result would be equally successful.

Overview of Major Reform Features

During 2003 two main legislative norms – the Social Insurance Act and the Old-Age Pension Savings Act – were prepared by the reform team. These two bills have set up the framework for the new pension system that was expected to operate in Slovakia from January 1, 2005. The Social Insurance Act set down changes in the unfunded pension system, Old-Age Pension Saving Act created a new, fully-funded pillar of the pension system.

The main changes brought by the Social Insurance Act were: the new model of calculating of old-age benefits paid by the unfunded pension system using the so-called “Personal Wage Points”, gradually increasing the retirement age to 62 years, a new structure of both mandatory pension contributions and benefits, and a complex re-definition of the disability benefits. Based on the Old Age Pension Saving Act, new Pension Companies were able to start their businesses in Slovakia, managing the personal retirement accounts of Slovak workers.

Prior to reform Slovak citizens were obliged to pay to the PAYGO system contributions reaching 28.75 % of gross

wage⁴⁰, and the system promised in exchange to pay an average old-age benefit 50 % of gross wage. The reform allowed workers to redirect a significant part of their contributions, 9 % of gross wage⁴¹, to their personal retirement accounts.

The system is mandatory for citizens who enter the labour market first time after January 1st, 2005. Citizens who decided that they were not going to retire earlier than after ten years, could opt for staying in the state-operated PAYGO system or switch to the new system within a period of 18 months⁴². All citizens who were already retired or wanted to retire earlier than in the next ten years were asked to stay in the state-operated system.

The pension funds, accumulating workers' pension savings are managed by private Pension Companies. The pension Companies are under strict supervision of the Financial Market Authority. Each of the pension companies set up three different pension funds, each of them having a different portfolio of securities. The Old-age Pension Saving Bill determines strict investment limits for each of the funds, based on type of securities, their issuers and ratings, with the main goal being to diversify possible investment risks.

40 18 % for old-age benefits, 6 % for disability and survivorship insurance, 4.75 % for Reserve Fund.

41 The single largest share redirected to the system of private retirement accounts in Europe!

42 January 1, 2005 and June 30, 2006.

Battle for private ownership of pension savings in 2003

From the description above one might wrongly assume that everything was almost perfect and without any problems during the preparatory stage of what finally became a successful pension reform. In reality just opposite was true. Firstly, there were growing disagreements over the size and parameters of the PAYGO. These disagreements forced Ivan Svejna and part of his team to depart from the ministry during 2003. Unfortunately, it did not wake up responsible politicians to make necessary adjustments in the PAYGO system and these changes will still need to be made in upcoming years.

There was even more serious source of tension, however. It was a question of ownership of pension savings. An overall situation with two crucial structural reforms, the flat tax and pension reforms looked optimistic, even rosy in autumn 2003. In my e-mail to Jose from November 1, 2003 I was able to report: *Dear Jose, let me start with a great news from Slovakia: the last Tuesday our parliament approved 19 % flat tax that would be effective starting from January 1, 2004. The most likely January 1, 2004 will be the beginning of the pension reform as well since this parliamentary session is discussing the last piece of the reform proposal.*

Anti-reform forces mobilized themselves in the very last moment and they used a debate on fiscal consequences of

the introduction of private retirement accounts for their own purposes. The EU intervened into our reform efforts by an announcement of Brussels that increased transition costs will not be tolerated and will be considered as a regular part of the deficit. This was a “cold shower” for some reformers and encouragement for anti-reformers which started to come up with the proposals how to meet a Maastricht criteria by keeping all financial flows of the reformed pension system within the public finances. In other words, how to have pension savings that will be accumulated at personal accounts of citizens in a public ownership instead of the private ownership.

This was one of the most important issues because without the private ownership the whole reform would be only mimicking the true reform. Fortunately, in the middle of the parliamentary debate on this issue, there was a visit of our parliamentary delegation to Chile that was scheduled for this period. The members of our parliament visited Santiago where they were having many meetings with people associated with the reformed pension system in Chile, including a special 3 hour meeting with Jose Pinera.

What happened during that meeting can be assumed from a following e-mail I received from Jose on December 9, 2003: *“Jan, Slovakia should approve a pension reform in which every worker OWNS his/her retirement account. I cannot support a reform in which the government owns the accounts, because there is a clear possibility that some*

government will in the future confiscate all or part of the workers hard earned money. It will be another big frustration for the Slovak people. I was very surprised to discover this key departure from the Chilean system only once the delegation was here. Nobody had told me about that. Since I am committed to principles, and not political tactics, I oppose that distortion of idea of private personal retirement accounts and I said that with full force and independence to Minister Kanik and the full commission (and all the deputies supported my position). Best, Jose”

The further acceleration of the next course of events can be clearly seen from my reply to Jose from December 11, 2003: *“Dear Jose, you have made a great impression on all members of our parliamentary delegation. After their return from Chile they were repeatedly making references to views of yours - as views of an already well known “classic” in Slovakia. I wish we could send there all our MPs, and all ministry staff, including minister, well before they started to work on the reform...”*

In following days, after many exciting debates and negotiations in a parliament, there was a right decision taken by our deputies. Minister Kanik could send his letter to Jose Pinera on December 19, 2003 starting in a following way: *„Dear Mr. Piñera, I would like to share some good news with you. Tuesday, on the 16th December 2003, the Slovak parliament approved the law on the old-age pension savings scheme. Thus, as of 1 January 2005,*

Slovak workers will start depositing 9 % into their personal savings accounts. These savings will be their private property, to which succession rights will fully apply.” And he continued: “Your visit to Slovakia had started an intense discussion about the pension reform, and enormously influenced the generation of a favourable political climate. I am confident that the pension reform, borne by your inspiration and with your significant assistance, will bring not only higher pension to our citizens, but also freedom and self-assurance while seeking out the correct way. The time of our visit to Chile coincided with the period of acute search for parliamentary support of the main law of the reform. The discussion with you made great impression, and contributed to a major extent to the determination and will of the members of our parliament to push through this historically new project of the pension system in our society. Ludovit Kanik”

The same day, December 19, 2003, Jose Pinera replied Kanik by e-mail: *„You have given me the best possible Christmas gift. Congratulations for a pension reform that, as you say, gives private ownership of their pension accounts to Slovak workers. ... I have already began to tell my network around the world that Slovakia, with its twin structural reforms (pension and flat tax), has become a leading reform country in Europe.“*

All in all, when we consider June 2002 as a sort of a kick off event of the true reform, there was a relatively very

short period of 30 months within which the reform was successfully debated, prepared, and finally implemented. In other words, the new world record in a discipline of pension reforms implementation was set up.

The second visit of Jose Pinera and June 2006 parliamentary elections

On June 17, 2006 there were parliamentary elections in Slovakia again. Pre-election public opinion polls were dominated by a leftist populist opposition party SMER with preferences close to 30 %. There were two major issues in their pre-election campaign: 1. heavy criticism of all reforms⁴³ adopted by a right-wing government, 2. promises of a reversal of the most of these reforms under a slogan of a reinstatement of a welfare state that is typical for continental Western Europe. Even the pension reform was demonised as a mere business for the private pension funds at the expense of pensioners.

In The Hayek Foundation we envisaged an escalation of these debates in our pre-election campaign well in advance. That is why we made a preliminary agreement with Jose on his second trip to Slovakia still back in 2005. We thought it was a good timing to invite Jose in May 2006 in order to defend the pension reform and its major results.

43 Described as irresponsible and even "brutal" social experiments on citizens.

When it came to a program of the visit, we decided and agreed mutually that we would basically follow the same pattern as during his first trip: 4 days, the conference on the pension reform, and many press, TV, and radio interview, and press conferences, including the major press conference with the minister of finance, Ivan Miklos. During this press conference Ivan Miklos announced that the pension reform was one of the most fundamental reform measures of the outgoing government that was already benefiting millions of workers accumulating billions of Crowns of the pension savings at their private accounts. Jose Pinera in his presentation congratulated the outgoing government and the minister for a well-done job while implementing the reform and underlined an importance of the reform for future prosperity of Slovak citizens and their economy.

In his keynote speech in the opening session of the conference on assessments of the first results and future prospects of the pension reform Jose summarised major contributions of the creation of the personal retirements accounts for improved performance of the Slovak economy, and above all, for increased standards of living and individual freedoms of the Slovak citizens in future. And he kept sending the same major message while making many follow-up interviews with both printed and electronic media.

In addition to media there were politicians and political parties among our target groups we aimed at by organising of this conference. That is why there was also a panel discussion with representatives of political parties where they had an opportunity to express their views on the pension reform, and to reveal their plans as far as a future of the reformed pension system concerned. 6 of 7 relevant parties having prospects to make it into the parliament made clear statement that they were satisfied with the pension reform as it was implemented and they had no plans to make any significant changes in it. It was only the 7th party, SMER, remaining as the only risk factor here, publishing their considerations of a reduction of payments to IRAs from 9 to 6 percent, or other intentions to make significant adjustments⁴⁴ in the reformed pension system.

Even though SMER finally won June 17, 2006 elections with a comfortable 29 percent, three right wing parties of the outgoing government coalition got 38.5, including the leading party of a Prime Minister Dzurinda with surprising 18.4 percent. Total results - 29 percent for left, 38.5 for right, and 20 for centre⁴⁵ - were not bad at all. All in all, the right wing parties were even in a position to continue staying in the power in case they would make an

44 Even to abolish the whole reformed system.

45 For two parties - The Slovak National Party and HZDS, Mr. Meciar's, the former Prime Minister (before 1998) party – declining to define themselves as neither left-wing nor right-wing party.

agreement with Mr. Meciar who changed his behaviour and strategy significantly during last four years⁴⁶. However, it was still not enough for Christian Democrats and they announced they would never form a coalition with Meciar, so this option was not explored.

The trick was that there were two other parties mentioned above with their total 20 percent. The new government was thus formed as a combination of leftist opposition party SMER lead by Mr. Robert Fico, and two other opposition parties with Mr. Fico as the new prime minister.

Despite these developments I was always confident that we would be able to achieve that the majority of the reforms would stay unchanged, namely the flat tax and pension reforms. For this to be true we needed to invest almost all our time and energy after June 2006 elections into lobbying and defending crucial reform achievements, including the pension reform. We used a strategy of a public campaign called “*Save the Pensions*” that was combined with internal lobbying via employers’ organizations and other pressure groups.

There was no guarantee that our voice would be heard⁴⁷, but mutual communication was still better than no communication at all. SMER as the strongest party of the

46 In a positive way.

47 There were also labor unions and other groups lobbying and having quite opposite priorities.

new government coalition used their right to nominate their nominees to be the ministers with crucial competences, including the ministries of labour and finance. Their statements after elections were significantly less radical as compared to their pre-election rhetoric. The new lady minister never repeated the pre-election fantasies about the abolishment of the reformed pension system. However, it does not mean that there is no threat anymore. The new government declared it will adopt Euro in 2009 and this goal can serve as potentially good excuse for its future efforts to reduce contributions to the reformed pension system in order to meet Maastricht criteria, especially 3 % maximum deficit of the state budget. On August 1, 2006 the new Prime Minister presented a government declaration of his government in the parliament. In its part dealing with a pension system there is much attention paid to ways how to improve a stability of the PAYGO system. On the reformed pension system the new government declares: "*the government will maintain the system of old-age pension savings system*". No single word on its abolishment, no single word on any potential plans to reduce the contribution rates. The only fundamental adjustment the government finally declared was its plan to make the reformed system voluntary. Though future consequences of this measure need to be analysed more in-depth, after more details of these plans will be released, of all measures that were considered by the government, this is of least dangerous ones. Its evils can be eliminated by improved marketing strategies of the pension

funds competing for their future clients with the PAYGO system. Of course, the government not making the PAYGO artificially attractive alternative for workers considering their personal options is a *conditio sine qua non* of this optimism.

At the very end of each story we usually want to have Happy End. As we know "*all is well that ends well*". Can this be considered as the Happy End of our Story? I do believe it can. Firstly, the new leftist government decided to keep the reformed pension system, although we will always need to stay alert and ready to fight against proposals to diminish the reformed pension system directly by reduced contributions or to undermine it indirectly by changing its other parameters. Secondly, the figures say it all: a total number of people switching to personal retirement accounts are more than 1.5 mil, about 70 per cent of all eligible people, with SKK 17.5 bln. accumulated pension savings at their privately owned savings accounts during the first 18 months of the reform.

V. Concluding Remarks

I know from my practical experience that in order to succeed in implementation of the fundamental changes there need to be several factors in place: 1. Open crisis – and in Slovakia we had it after 1993-1998 period of irresponsible macroeconomic policies, and the lack of microeconomic adjustments, 2. Appropriate inspiration and reform model – and we had them in Jose Pinera, and his reform efforts in Chile, 3. A free market think tank and "do tank" – we had The F. A. Hayek Foundation, 4. Politicians ready and willing to implement the necessary reform steps – we had Ivan Miklos, and Ludovit Kanik.

Even if all four factors would be in place at the same time, it still does not need to be sufficient. There is still another factor that needs to work in favour of reform efforts. The framework conditions need to be supportive as well. If minister Magvasi would be able to get approval for his bad reform proposal, there would be no true pension reform based on private pension savings. If the two leaders of the Slovak National Party would not started quarrelling before 2002 election and would not split the party, Mikulas Dzurinda would not be able to form his second government. If the parliamentary delegation trip to Chile would not coincide with the debate on ownership of pension savings, the most likely we would have a very different pension reform. Consequence: if also the

framework conditions would not be working in favour of reform forces, there would be no pension reform as it was finally adopted.

Once again, all of these factors – open crisis as a starting point, appropriate inspiration and reform model, a small group of dedicated free marketers, and politicians able and capable to implement necessary reform steps, and generally favourable framework conditions – needed to be in place in order to make radical the reforms in Slovakia possible, including the pension reform. I am sure the same can be done in every single country in the world that is still on Jose´s list of non-reforming countries. And hopefully, after a reading of this Story someone from one or more of these countries will get inspired and will start to make the first small steps on the same reform path as we did many years ago in Slovakia.

Bratislava, September 1, 2006

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Mr. Ján O R A V E C graduated in 1987 from **Comenius University in Bratislava** (Philosophy – Political Economy), **The Swinburne University of Technology, Melbourne, Australia** in 1994 (Business Administration) and **Southern Methodist University, Dallas, Texas, USA** in 1993-1995 (Bank Management). In 1996 he received his PhD. degree in economics at the **Institute of Slovak and World Economy in Bratislava**.

He started his professional career at the **Institute of Economics of the Slovak Academy of Sciences** in 1987. In the beginning of 90-ies he was active in financial sector (financial manager in investment fund, Director of the Investment Banking Dept. in Devin Bank, internships in Banc One, Dallas, Texas, USA and Westpac Bank, Sydney, Australia).

In 1999-2002 Mr. Oravec was working as a **Chief of Strategy at the Ministry of Economy of the Slovak Republic** where he was working on restructuring and privatisation of utilities and improvements of business environment in Slovakia. During that period he served as a **chairman and member of various Supervisory Boards** (SSE, a.s., - one three regional electricity distribution companies, The Slovak Guarantee and Development Bank, Transpetrol, a.s., Slovak Consolidation Agency, Slovak Post-Privatisation Fund), a **chairman of a Board of Directors** (National Agency for SMEs) and a **vice-Chairman of the Government Council for Science and Technology**. In this period he also represented Slovakia in key economic committees of the OECD.

In October 2003 he was elected as a President of The Entrepreneurs Association of Slovakia, the first organisation of private entrepreneurs in Slovakia after a collapse of communism. **He is a member of a Presidium of The National Union of Employers**, the most representative organisation of employers in Slovakia. He represents Slovak employers in the **European Economic and Social Committee** in Brussels, and in the **Slovak Council of Economic and Social Agreement** in Bratislava. He is also the member of the **Economic Council of the Slovak Government**, and in 2002-2006 he was a member of the **Collegium of the Finance minister**.

Since 2004 he is a member of a *Scientific Board of a Faculty of Economics and Public Administration, The University of Economics in Prague*, and a member of an *Industrial Board of The Slovak University of Technology in Bratislava*, since 2004 he is also a member of an *Academic Board of a Liberal Institute in Prague*. He is a founding father of ***The F. A. Hayek Foundation Bratislava*** (established in 1991), and ***The Slovak Taxpayers Association*** (1997).

He is an economic advisor, he writes articles, gives lectures, TV interviews, and public speeches on various topics.

About the F. A. Hayek Foundation

The **F. A. Hayek Foundation Bratislava** - is an independent and non-political, non-profit organization, founded in 1991, by a group of free-market oriented Slovak economists.

The core mission of the F. A. Hayek Foundation is to establish a tradition of market-oriented thinking in Slovakia – an approach that had not existed before the 1990's in our region. From this classic liberal tradition, to offer practical reform proposals for market solutions to economic and social problems; in the reform process to widen and propagate throughout Slovakia classic liberal ideas, provide a platform to exchange of ideas of experts and the broader public, and develop the basic liberal ideas and values.

The F. A. Hayek Foundation remains active in several main issues of public policy: pension reform, taxation, public finance, EU integration and harmonization, privatization, education reform, and many others. Our most ambitious goals for the next years include introducing the “Fiscal Responsibility Act” into Slovak legislation, or increasing the quality of Slovak economic education.

One of the most successful projects of our institute was the founding of the Slovak Taxpayers Association, which fights against excessive financial tax burdens on citizens and businesses and tries to increase the public awareness about

tax matters. Promoting balanced state budget, lower taxes and public expenditures, Slovak Taxpayers Association has become of the best recognized public policy organizations in Slovakia, with 51 % brand public recognition according to a recent public opinion poll.

In 2004, The **F. A. Hayek Foundation** was awarded the **distinguished Templeton Freedom Award for Institute Excellence** for its impact and efforts in promoting liberty and market principles in Slovakia. In addition to this, a special USD 10,000 grant and Templeton Freedom Prize for Initiative in Public relations were awarded to the F. A. Hayek Foundation by US-based organizations, *The John M. Templeton Foundation* and *Atlas Economic Research Foundation*.

