EAEPE 2007 Conference

Economic growth, development, and institutions - lessons for policy and the need for an evolutionary framework of analysis

Porto – Portugal
November 1-3, 2007

The European Social Model and Old-age pension reforms:
The case of Central European and Baltic Enlargement countries

Cristina Matos
NEEII and EEG, Universidade do Minho, Portugal

Work in progress!

List of abbreviations:
CEE – Central European and Baltic Enlargement countries (these are Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia)
EC - European Commission
ESM – European Social Model
EU - European Union
OMC – Open Method of Coordination
PAYG - pay-as-you-go
Introduction

This paper analyzes the affinity between the European social model and old-age pension reforms in Central European and Baltic Enlargement countries (CEE). We deduce the European social model on old-age pensions, alternatively from EU15 national experiences and from EC documents. Afterwards, we confront old-age pension systems in CEE with the deduced ESM.

CEE EU accession influence on old-age pension reforms was less pervasive than World Bank impact. Contrary to World Bank, EU supported actions were dispersed and not clearly oriented towards defined objectives (Deacon and De la Porte, 2004). Social acquis is soft; thus, unlike hard acquis it assumes the form of recommendations, rather than directives. Social policies were under-represented in Copenhagen criteria (e.g. Ferge and Juhász, 2004; Vaughan-Whitehead, 2003). While, “on the rhetorical level, Brussels has not ceased to emphasize that Europe represents a unique social philosophy and quality on the globe, on the pragmatic level, it has made it clear that the welfare status of the would-be members does not feature at the top of the list of enrolment criteria” (Kovacs, 2002: 199-200).

Yet, the situation has evolved since the Copenhagen criteria were established, in March 1993. Since 1997, EU member states coordinate employment policies. Three years later, the Lisbon Strategy expressed, EU’s willingness to articulate efficiency and equity.¹ Consistently, the twin social inclusion and pensions Open Method of Coordination (OMC) were introduced in March 2001. This paper confronts CEE pension systems and OMC streamlined objectives.

We assess pension systems by comparing how these organize three building blocks: Protection, insurance and financial stability.

The organization of Protection is influenced by solidarity concerns. We distinguish universal and non-universal old-age pensions systems. Universal systems provide minimum or guaranteed pensions. Non-universal basic pension is conditional on minimal contribution record. Both minimum and basic pensions can be means-tested. Protection is further fostered by indexation to price increases or to life-style variations.

¹ Lisbon strategy’s central aim was to produce “the most competitive and dynamic knowledge-based economy, capable of sustainable economic growth with more jobs and greater social cohesion”.

2
The insurance building block organizes around the aim to guarantee pensioners a stable life-style; it includes the benefit-contribution link as well as indexation. Insurance organization can be public or private and include alternative benefit determination models. In a PAYG system, contributors finance directly present-day pensioners. Traditionally, PAYG systems are defined benefit (DB) type and benefits are determined bureaucratically. On the other hand, in defined contribution (DC) systems, benefits will be determined alone by contributions and yielded returns. The insurance building block also includes private funds, which can be voluntary and compulsory.

The financial sustainability block is related to the capacity to resist exogenous shocks (e.g. demographic and socio-economic changes). Reforms aim to promote financial sustainability. We can distinguish between systemic and parametric reforms. Systemic reforms change the nature of the pension system; for example, they can introduce private compulsory insurance (or pension privatization). Conversely, parametric reforms only alter some parameters, like entitlement conditions or the DB benefit formula.

Economic old-age pensions analysis generally focuses on financial considerations and on labor market outcomes. There are important controversies over the best features. While World Bank (1994) and Holzmann (2004) underline the problems of PAYG systems and call for private funds, Barr (2000) as well as Stiglitz and Orzsag (2001) underline the potentialities of public schemes. Our paper does not directly address this topic. It discusses how national pension systems integrate alternative models.

We develop an institutionalist framework, where old-age pension system dynamics is shaped by bargaining as well as exogenous and path-dependent processes. National bargaining processes are institutionally embedded.

We use path dependence to refer to an irreversible branching process (David, 2002) whereby branch switching is costly. For example, pension privatization entails important switching costs, known as transition costs, which are financed out of the PAYG budget.\(^2\) Pension reforms are also path dependent in the sense that the old-age pension system emerges from the composition of successive reforms and

---

\(^2\) Transition costs following privatization result from the fact that an unfunded system must share contributions with a funded one. In the first years, both pensioners and the constitution of private fund reserves will be paid out of the PAYG budget.
amendments. In this sense, pension reform process is an irreversible branching process.

Branching processes emerge from cumulative causation and positive feedback. While pension systems are institutionally embedded, successive reforms in turn shape anticipations and influence social values. Furthermore, bargaining is a source of path dependence, since power distribution depends on the specific reform history. For example, private pensions introduction develops new interest groups and, in turn, will strengthen the group of those calling for pension privatization.

Path dependence structures the *hybridisation* or *recombination* of existing pension models and national legacies. Stark (1997) as well as Grabher and Stark (1997) use the notion of *recombination* to emphasize new routines emerge from the recombination of new elements and legacies. In this sense, “legacies are not simple residues from the past but can serve as resources for the future” (Grabher and Stark, 1996). Against a tabula rasa perception which would underline institutional design, Stark (1996: 36) sustains organizations and institutions are rebuilt “not on the ruins but with the ruins of communism”.

In our analysis, *recombination* processes hybridize models of (parametric and systemic) reforms with path-dependent elements. Reform is an institutional *embedded* process, shaped by socio-cultural-economic values and by the balance of power between different groups of interest.

While *recombination* increases national divergence, tolerated diversity will be limited by the dominant economist discourse, EU coordination and *cognitive Europeanization* (Guillén and Alvarez, 2004). Particularly, economic models and EU-level guidelines are frequently used to legitimate unpopular measures. Conversely, fragmented EC discourse will enhance national-level and hybridization.

1. **Old-age pensions and the *European Social model***

1.1 *What we mean by “European Social model”*

In this paper, we derive the *ESM* in the field of old-age pensions, simultaneously, from common features in EU national old-age pensions and from the principles set forth by EC documents (*or soft acquis communautaire*). These perspectives are partly complementary; on the one hand, EC documents rest on

---

3 See, e.g. for France, Palier (2003), and for Portugal and Ireland, Norris (2006).
national experiences; on the other hand, EC communications act as focal points that orient national processes.\(^4\)

The expression *European social model* is generally used to underline EU “*strongly institutionalized and politicized forms of industrial relations*” (Grahl and Teague, 1997: 405), supporting workers’ rights, improved wages and decent working conditions, as well as promoting equal opportunities, anti-discrimination, social dialogue and social protection (Vaughan-Whitehead, 2003; Lessenich, 2003).

Although the notion of *ESM* is dear to the EC, it «*has never been clearly defined*» (O’Hagan, 2002: 121-2). Consistently, it allows national interpretations (Guillén and Palier, 2004: 206) and thus hybridization. In the case of CEE, accession implied a considerable terminological adaptation, since “*terms such as social exclusion, social inclusion, gender mainstreaming, social cohesion, policy coordination, etc. have been highly novel*” (Lendvai, 2004). Thus, statistical methodologies, economic terminologies and national social policies develop simultaneously.

Social policy analysis often underlines intra-EU diversity. For example, Castels (2004) highlights EU social spending divergence and considers the *ESM* is merely *an in house product of the EU institutions*. Esping Andersen (1990, 1999) also noted welfares states in Ireland and UK, as well as Denmark, Finland and Sweden are more similar to external countries (respectively USA, Australia and Canada on the one side, and Norway on the other) than to their EU neighbors.

In spite of its conceptual limits, we will keep the expression *European social model* to refer to common trends in EU countries and to soft-*aquis*. Our analysis, will not conceal diversity. We contend divergence is enhanced by hybridization and by EC discourse ambiguity.

**1.2 Pension systems in EU-15**

---

\(^4\) For the concept of *cognitive europeanisation* see Guillén and Alvarez (2004).
Table 1. Protection and Indexation in EU15 old-age pensions systems

<table>
<thead>
<tr>
<th>Coverage</th>
<th>Type of protection</th>
<th>Indexation method</th>
<th>EU15 countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Universal</td>
<td>Means-tested Minimum Pension</td>
<td>To CPI increase</td>
<td>France, Spain, UK</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Annual ad-hoc</td>
<td>Ireland, Portugal</td>
</tr>
<tr>
<td>Non Means-tested Minimum Pension</td>
<td>To wage growth</td>
<td>Denmark, The Netherlands</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>To both CPI and wage developments</td>
<td>Finland, Sweden</td>
</tr>
<tr>
<td>Non-universal</td>
<td>Basic Pension after qualifying</td>
<td>To CPI increase</td>
<td>Luxembourg, Belgium, Greece, Italy &lt;1995</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Annual ad-hoc</td>
<td>Austria</td>
</tr>
<tr>
<td></td>
<td>Social assistance only</td>
<td>(all pensions are indexed to inflation)</td>
<td>Germany, Italy &gt;1995</td>
</tr>
</tbody>
</table>


In table one, we identify four different forms protection models in EU-15. In universal systems, a minimum pension in paid after entitlement age, independently of contributions made; its attribution can depend on means-test or not. Most non-universal systems offer a means-tested basic pension after a certain contributory record. Like German pensioners, Italian labor market entrants after 1995 will only be protected by (means tested) social assistance.

Indexation is a common ingredient in EU15 countries’ old-age pension systems. Table one shows four different indexation methods are used. In ad-hoc indexation, protection is subject to electoral cycle and to budget concerns. CPI indexation privileges protection against inflation, while wage increases indexation accommodates for national living standards progress. It is interesting to remark wage increase indexation only developed universal non-means-tested protection. In this group, Finland and Sweden protect pensioners against both price and life-style progress. Indexation also concerns insurance and particularly the relation between inactive and active population incomes.
Table two depicts the organization of insurance in EU15. Although PAYG public insurance is the rule, national arrangements are different. Unlike their EU neighbours, UK citizens can opt-out of the PAYG system. Among PAYG arrangements, we distinguish the most common organization, defined benefit (DB) from flat-rate benefits (Denmark and the Netherlands) and defined contributions (DC). In notionally defined contributions (NDCs), individual contributions, and respective returns are converted into a stream of pension payments using a formula based on life expectancy.

**Table 2 Insurance in EU15 old-age pensions systems**

<table>
<thead>
<tr>
<th></th>
<th>Unfunded Public (PAYG)</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DB</td>
<td>DC</td>
<td>Flat-rate</td>
</tr>
<tr>
<td>Compulsory private</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Funded</td>
<td>Finnland (5%;12%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private</td>
<td>UK* (45%;14%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Denmark (95%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Netherlands (90%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unfunded</td>
<td>Belgium (45%)</td>
<td>Sweden (90%;40%)</td>
<td></td>
</tr>
<tr>
<td>Private</td>
<td>France (10%;8%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Voluntary Private</td>
<td>Austria (35%;10%)</td>
<td></td>
<td>Italy (8%;2%)</td>
</tr>
<tr>
<td></td>
<td>Germany (60%; -)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Greece (&lt;1%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Ireland (52%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Luxembourg (20%;5%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Portugal (4%;1,5%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Spain (4%; 41%)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Values presented in brackets correspond to the percentage of employment covered by private funds; where separate data are available, occupational and individual fund coverage is presented separately and in this order.

* UK citizens can opt-out of the PAYG pension system.


Although they are frequently voluntary, private pension funds are compulsory in Belgium (depending on collective agreement), Denmark, Finland, France, the Netherlands, UK and Sweden. Be they voluntary of compulsory, occupational funds cover an important part of employment in most countries. Conversely, they are unpopular in Finland, France, Greece, Italy, Portugal and Spain (see values in brackets). Global private pensions employment coverage is weak in Greece, Italy and Portugal and very significant in Denmark, Netherlands and Sweden.

A variety of insurance arrangements coexists in EU15. This leaves
considerable latitude within the *European social model*. National reforms introduced elements from different arrangements and as such enhanced *hybridisation*. This increased *ESM* diversity.

We can identify five major recombination processes in EU15 old-age pension systems. The first is the NDC model, which combines PAYG funding, with benefit determination rule imported from private funds. The second is the development of defined benefit private funds; in Ireland, 70% of occupational funds operate in a DB basis (EC, 2006c); in Belgium, France and Sweden, private funds are DB and unfunded. The development of occupational funds is a third recombination process; in EU15, these are managed privately but are framed by collective agreements; furthermore they are, like PAYG and contrary to individual funds, financed by employer contributions. A forth hybridisation process occurred in UK, where 60% of the employed opted-out of PAYG pensions (EC, 2006c); here, mandatory private pensions and voluntary PAYG are the antithesis of the biggest cell in table three. Finally, the fifth recombination process encompasses the introduction of funding principles into PAYG systems; this involved different strategies, namely the constitution of special *ageing-related* funds.

Recombination results particularly from combining features of PAYG and private funds. PAYG resilience emerges from a branching process, resulting from *transition costs* and from positive feedback. PAYG arrangements act as focal points, which influence private pension developments (benefit determination and funding). In turn, private fund arrangements are also focal points for PAYG reforms (e.g. NDCs simulate funded systems).

To conclude, an *ESM* on old-age pensions based on the minimum common denominator across EU15 experiences, includes:

- Important latitude for national diversity.
- The existence of four protection models, including universal protection, means-tested or not, and non-universal means-tested protection (with basic pensions or not).
- Only in universal non-means-tested protection systems are pensioners protected against life-style progress. Other countries protect pensioners against inflation.
- State, PAYG insurance exists in all EU15 countries, where it is organized around three alternative modalities: DB, DC and flat-rate.
- Private pensions are voluntary in eight countries and compulsory in seven. Their
coverage is very different across EU15.

- In nine countries, private pensions are predominantly occupational.

1.3 Old-age pensions coordination in the EU

Social policies entered the EU agenda partly because of their effect on economic phenomena (Leibfried, 1995). Palier (2003) also underlines the impact of political factors (e.g. enlargement and governmental changes) in social policy coordination. A bipolar structure emerged, giving power both to voices calling for flexibility (particularly DGII-economic affairs) and to those calling for security (e.g. DGV-social affairs). Their articulation explains the development of coordination in the field of social policies, whose first experiments were the Luxembourg process and the employment Open Method of Coordination (OMC). Later, EC developed the twin OMC’s on pensions and social inclusion.

The OMC harmonizes ideas, rather than policies (Palier, 2003). Under the OMC, national representatives present their National Strategy Reports (NSRs), discuss their experiences and coordinate strategies around certain streamlined objectives.

The first central aim was to promote financial stability in an economic environment marked by demographic shocks and globalisation. Successive EU Councils refined the formulation of common objectives. From 2001 these are organized around three blocks:

i) Pension adequacy (preventing social exclusion, maintaining living standards and promoting inter- and intra-generational solidarity);

ii) Financial sustainability (extending working lives, increasing employment rates and providing sustainable pensions in the context of sound public finances);

iii) Societal dynamics (adapting to more flexible employment and careers, promoting gender equality and promoting consensus).

The 2006 recommendations (EC, 2006) added two new objectives: to secure private pensions and to support pension systems governance.

Efficiency and equity goals are entrusted to two distinct committees. The Economic Policy Committee promotes efficiency, particularly financial sustainability objectives, and guarantees the Stability and Growth Pact through Broad Economic
Policy Guidelines. The Social Protection Committee promotes equity (protection and insurance) and influences national reforms through the OMC.

Table three sums up major recent EC documents on old-age pensions and underlines major ideas in the fields of protection, insurance and financial stability. This formulation is conceptually different from tables one and two, which were built on existing old-age pension systems. Table three focuses on how the EC would like systems to be. Furthermore, EC documents result from compromises between committees and reflect the political orientation of commissars as well as political orientations of national governments and the European Parliament.

### Table 3 – The old-age pensions ESM derived from recent EC documents

<table>
<thead>
<tr>
<th>Protection</th>
<th>Insurance</th>
<th>Stability</th>
</tr>
</thead>
<tbody>
<tr>
<td>EC communications</td>
<td>Minimum pensions;</td>
<td>Funding;</td>
</tr>
<tr>
<td></td>
<td>Indexation to living-standard progress</td>
<td>Work longer;</td>
</tr>
<tr>
<td></td>
<td>Adequate income replacement;</td>
<td>Adaptability;</td>
</tr>
<tr>
<td></td>
<td>Secure pensions</td>
<td>Voluntary schemes</td>
</tr>
</tbody>
</table>


*Protection and insurance* match the first Pensions OMC streamlined objective. Its indicators include poverty risks, ratio to active person’s income, aggregate replacement ratios and income loss after retirement. Protection is a key function of EU old-age pensions. EC clearly endorses minimum pensions, which should be articulated with other social protection. Documents call for the introduction of universal protection and income growth indexation.

*Insurance* should be based on a transparent and demographically sustainable benefit – contribution link. Although EC documents do not arbitrate over possible benefit determination, documents are enthusiastic on the impact of NDCs and advise benefit formula should incorporate the complete contribution history. This reflects a change in old-age insurance towards a stronger individualization. Conversely, previous EU system built on a paradigm of social insurance, similar to the unemployment and sickness insurance.

---

5 *Pension systems based on universal coverage have the largest ability to cover uncertainties related to long-term commitments to provide adequate old-age income.* (EC, 2005).
To balance the effects of irregular work histories, old-age pension systems should permit voluntary participation in private and PAYG systems. Improving insurance also involves securing private systems and improving public system governance.

“There are strong grounds based on equity and efficiency for government involvement in pensions, be it provision, financing or regulation. This is in particular linked to basic social objectives, such as securing adequate income in the old-age...” (EC, 2005). The state should “ensure the financial sustainability of public and private pension schemes” (idem). Indeed, except for the UK, public pensions remain the core of EU15 old-age pensions.

Financial stability should be promoted by transition towards (private and public) funded systems. This collides with PAYG dominance in EU15; as we have seen individual countries have created special funds to address ageing.

Streamlined sustainable pensions indicators include actual and projected pensions expenditures (% GDP), employment rate with age and gender breakdown, the average age of withdrawal from labor market. Active ageing will improve dependency ratios. In line with the Lisbon more and better jobs objective, OMC streamlining includes reaching a 50% employment rate of workers aged 55-64 and increasing the effective labor market exit age should be increased by 5 years. In order to increase older worker employment, EC (2004) advises both encouraging people to retire later and life-long learning, active ageing, wage flexibility and changing firm perceptions towards active ageing.

If we were to define the old-age pensions ESM based on supra-national activities and recommendations, we would underline:

- State surveillance and / or management of old-age pensions is chief;
- Pensioner protection against poverty is considered essential;
- Benefits should reflect accurately the individual contribution record;
- Financial sustainability goals are central in evaluating reform alternatives. Particularly, EC documents recommend a transition to funding;
- Old-age pension system adaptability and flexibility demands considerable parametric changes.
1.4 Confronting the ESM and the World Bank

It is widely established World Bank had an influence on old-age pension reforms in CEE (e.g. Müller, 2003; 2002). In this subsection we analyze how this might have affected the affinity between CEE and ESM of old-age pensions. To do so, we identify major similarities and differences between the World Bank propositions and the ESM in the field of old-age pension reform.

World Bank approach to old-age pension reforms has evolved. The World Bank (1994) guidelines have been actualized by Holzmann (1999) and by World Bank (2001). Furthermore, the 1994 propositions were criticized from within the Bank by Stiglitz and Orszag (2001). Finally, World Bank engagement on old-age pension reforms in Hungary, Latvia and Bulgaria was recently evaluated (vide Palmer, 2007).

The World Bank (1994) model puts forward a three-pillar model combining:
1. A mandatory public pillar, restricted to means-tested social assistance;
2. a compulsory funded pillar privately run and publicly regulated pillar, granting contribution-related benefits; and
3. a voluntary private pillar, financed out of individual contributions.

This approach is expected to induce deferred retirement and to boost economic growth. It is also expected to protect pensions because it diversifies economic and political risks (Holzmann, 1999). World Bank (2001) prefers to consider this three-pillar model as a benchmark rather than a blueprint.

World Bank’s propositions shaped old-age pension reform in Latin America as well as in post-socialist countries (including CEE) (Müller, 2003). They also affected Western European reforms indirectly, through the pension reform epistemic community (Müller, 2002; 2003). Furthermore World Bank and IIASA sponsored the “learning from the partners” 2001 conference designed to ease systemic reforms in EU15. It paired one systemic reformer with one parametric reformer among EU15 and ten enlargement countries plus Croatia. Each established a report on the other’s pension reform.

Table four confronts the three-pillar model and the ESM. A major difference between this proposition and the ESM is the role of the State. In EU15 as well as EC documents ascribe the state an important role in protection, insurance and private fund supervision; in the WB three-pillar model, the role of the State is limited to protection and supervision. Actually, although World Bank (1994) and Holzmman (1999)
contest state insurance, some countries under Bank advice kept a reformed public PAYG.

World Bank (1994) blueprint built on the Chilean experience and clearly opposed PAYG pensions. It considered public PAYG pensions entailed unsustainable benefit formulas and unsustainable payroll taxes. Furthermore, they would have led to capital misallocation, because they financed unproductive investment and diverted savings. Therefore, dependence ratios deterioration resulted both from exogenous shocks (demographic and societal) and from endogenous processes which cut-down employment,\(^6\) and increase the numbers of pensioners.\(^7\)

Before World Bank supported pension reform in CEE, an alternative, model pension model developed in Latin America, including an enlarged first pillar providing both protection and insurance (known as the Argentinian model). More recently, World Bank (2001) considers macroeconomic feasibility and financial stability should guide specific reforms. Stiglitz and Orszag (2001) further contextualize the relative merits of private pensions over public systems.

EC and World Bank share the same approach to the consequences of demographic imbalances and socio-economic transformations (e.g. atypical employment) on financial stability. Furthermore, they both insist these should be overcome through elder-employment and life-long-learning. Yet, there are some divergences over the relative potentialities of NDCs and public funding.

EC’s attitude \textit{vis-à-vis} NDCs is more optimistic than Holzmann (1999), who sustains NDCs have a poorer effect on savings and on labor markets than private schemes (Holzmann, 1999). Palmer (2007) also underlines national preferences (rather than World Bank proclivity) explain Bank experts cooperated with Swedish specialists in the introduction of Latvian NDCs.

Furthermore, in theory, public pensions can be funded (e.g. Barr, 2000). Indeed, neither EC (2006) nor Stiglitz and Orzsag (2001) discriminate between public and private funding. Still, in his assessment of World Bank’s approach, Holzmann (1999) considers governments lack motivation to promote funding. Consequently, even where a PAYG is kept, its replacement ratios are expected to decrease as private

\(^6\) High contribution rates and crowding-out would have slowed employment creation.
\(^7\) Badly designed pension schemes would have encouraged early retirement.
pensions develop. Conversely, in EU15, replacement ratios are relatively high (as we shall see in chart three).

Considering protection, both EC and World Bank distinguish protection and insurance. They similarly consider protection is achieved through means-tested assistance and the indexation to prices and wage dynamics. Nevertheless, while EC unmistakably considers inclusion to be a productive asset, the World Bank regards protection as a poverty reduction instrument.

### Table 4 – The World Bank and EC approaches to pension reform

<table>
<thead>
<tr>
<th>Protection</th>
<th>Insurance</th>
<th>Financial sustainability</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Common Features</strong></td>
<td>Minimum pensions</td>
<td>Indexed CPI and wage dynamics</td>
</tr>
<tr>
<td><strong>Divergences</strong></td>
<td>An asset or assistance?</td>
<td></td>
</tr>
</tbody>
</table>

Opposite to the original three-pillar model, EU15 old-age pensions are dominated by PAYG pensions. Unfunded PAYG is a path dependent feature of EU systems, both Bismarkian and Beveridgean. Furthermore, EU15 private pensions, both compulsory and voluntary, are frequently occupational.

In common with the three-pillar model, EU15 protection is often means-tested. Moreover, almost half EU15 systems include compulsory private pensions. Undoubtedly, the British pension system, with a voluntary PAYG and compulsory private pensions is the closest to World Bank propositions.

## 2. Old-age pensions in CEE

### 2.1 Old-age pension dynamics in CEE

Under central planning, CEE countries had similar old-age pension arrangements. «In common with West European societies, state socialist social policy was dovetailed with labor policy» (Manning, 2004: 214). Still, relative to his contemporary EU15 pension systems, incentives were paramount under social planning. Here, old-age benefits were “a worker’s privilege rather than a citizen’s right” (Wagener, 2002). Benefits and eligibility were conceived to be coherent with
industrial policies (de Deken, 1994: 75). Marginal groups like farmers and the self-employed were only recently integrated into pension systems.

Incentives were designed to fuel participation and pensioners often worked. Indeed, although entitlement retirement age was usually below Western Europe replacement rates were lower, and often beneath 50%. Consequently, activity rates were important in unreformed central planning systems and lower in Hungary, Poland and Slovenia.

Central planning legacy is a mixture of bureaucratic incentives to work and low replacement rates with specific budgetary arrangements. Pension fund was managed by the central budget (regional budget in Slovenia) and financed out of employer contributions and taxes.

Economic transformation entailed significant and successive pension reforms. In spite of an important diversity, early and mid-1990s CEE pension reforms included:

i) The separation from central budget and development of collection mechanisms;
ii) The introduction of minimum / basic pensions in line with the establishment of a social security nets;
iii) The introduction of (ad-hoc) indexation, compensating for considerable price increases;
iv) The increase of contributory rates and the introduction of employee contributions;
v) Benefit formula change meant to enhance the benefit-contribution link; and

These reforms changed the logic and organization of previous old-age pension systems. These reforms brought CEE pension systems closer to Western European PAYG. Pension reforms are part of a more general transformation of the state welfare system into Bismarkian social insurance (Wagener, 2002). If we perceive these are two different systems, we cannot classify these reforms as parametric (as do e.g. Barr and Rutkowski, 2005).

Reforms did not increase retirement age, men could usually retire at 60 and women at 55, which is lower than in most EU15 countries. The low retirement age, which did not affect activity rates under central planning facilitated early 1990s activity decrease. This was a consequence of post-socialist crisis, coupled with the
expansion of unrecorded employment (Matos, 2005). Activity contraction combined
different processes, particularly early retirements, postponing labor market entrance
and female inactivity expansion (Matos and Rodet-Kroichvili, 2006). Activity rates
decline was most impressive in Bulgaria, Estonia, Hungary, Latvia, Poland and
Romania.

World Bank (1994) gave special attention to CEE «high and rising dependency
..., soaring fiscal costs, bloated contribution rates and negative returns to pension
reserves» (p. 284). Whereas it only suggested three pillar models, the report
considers «the introduction of a decentralised second pillar would have a special
political and psychological benefits in transitional economies» (World Bank, 1994:
286).

By the mid-1990s, old-age pension systems in CEE experienced different
financial conditions. In countries such as Czech Republic, Lithuania and Slovakia,
central budget subsidies were low. In other countries, however, expenditures
increased importantly, boosting central budget subsidies and old-age pensions
systems became unstable. Financial strain intensified World Bank advice in the later
group; hence, except for Slovenia, the later group promptly adopted compulsory
private pensions (Müller, 2002; 2003).

The World Bank three-pillar approach encapsulated focal points, which oriented
CEE old-age pension reforms. For example, the Polish pensions reform was coined
“security through diversity” echoing the idea that introducing private pensions
enhances security is also conspicuous in World Bank (1994) and Holzmann (1999).
Hence, second pillar pensions were introduced in Hungary (1998), Poland (1999),
Lithuania introduced in 2004 a peculiar system, where participation in the private
pillar is voluntary yet irreversible; furthermore, like second pillar pensions (and
unlike third pillar), Lithuanian private funds are financed out of pension contributions.

All late 1990s CEE PAYG reforms responded to financial strain. They
increased retirement age and particularly female retirement age. Except for Polish
farmer pensions, special systems were separated from the PAYG. Benefit calculation
formula increased the number of years considered, thus enhancing individualization.

8 In Slovenia, in spite of an important debate over private compulsory pensions, the 1999 reform chose
to introduce only private pensions voluntary.
Benefit-contribution link was particularly enhanced by NDC introduction in Latvia (1996) and Poland (1999). NDCs have become very popular and are also envisioned in Czech Republic (by 2010) and Hungary (by 2013) (Wagner, 2005).

2.2 Confronting CEE old-age pensions and the European Social Model

We now examine whether current CEE old-age pension systems respect the ESM as derived in section one. This sub-section is organized around OMC streamlined objectives. It confronts old-age pension systems in CEE both with EU15 systems and with EC propositions.

Table five depicts old-age pensions protection and insurance arrangements in CEE and EU15. This table orients discussion throughout section. A line WB introduces the basic three-pillar model from World Bank (1994). For CEE countries, the last column in table five is divided into two. It first presents private pension coverage (for EU15 data was presented in table two). Where a compulsory system exists, data discriminates between compulsory and voluntary pension coverage, which are presented in this order. For each CEE country, the last cell indicates the population group to whom private pensions are compulsory. These are usually compulsory before a certain age (30 or 40 years old) or to new entrants (NE) whereas in Romania private pensions are compulsory to all those retiring after 2025 (R>2025).
### Table 5 – CEE and EU 15 Protection and Insurance (2006)

<table>
<thead>
<tr>
<th>Indexation methods</th>
<th>Protection</th>
<th>Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>MTMP</td>
<td>Non MTMP</td>
</tr>
<tr>
<td>P+W</td>
<td>WB</td>
<td></td>
</tr>
<tr>
<td>P/ad-hoc</td>
<td>MTSA</td>
<td>US (voluntary)</td>
</tr>
<tr>
<td>W/P+W</td>
<td>MTSA</td>
<td>Austria, Belgium, Germany*, Greece &amp; Luxembourg</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sweden, Denmark, Netherlands</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>P</td>
<td>MTSA</td>
</tr>
<tr>
<td></td>
<td>W</td>
<td>aust-W</td>
</tr>
<tr>
<td></td>
<td>ad-hoc</td>
<td>Bulgaria</td>
</tr>
<tr>
<td></td>
<td>P+W</td>
<td>MTSA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Latvia &amp; Poland</td>
</tr>
<tr>
<td></td>
<td>ad-hoc</td>
<td>Romanija</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Lithuania</td>
</tr>
</tbody>
</table>

Legend: (*) No basic Pensions in Germany; (-) no data; NE new labor market entrants
MTMP – Means-tested minimum pension; MTB- Means-tested basic pension; MTSA - Means-tested social assistance;
P- CPI Indexation; W – Indexation to wage increases
Sources: EC (2006c), Holzmann et al. (2003), Missoc (2006), OECD (2005), Rother et al. (2003), World Bank (1994)

### 2.2.1 Protection and Indexation

Among CEE only Estonia, Hungary and Romania respect EC guideline on universal pension protection. In other CEE universal protection is delegated to means-tested social assistance. Among these, the most common arrangement includes a basic pension to those having contributed for a minimum period. Like in Germany and in the new Italian system, there are no basic pensions in Lithuania and Slovakia, where pensioners are protected by general social assistance.

Although protection arrangements are close to EU15, minimum and basic pensions in CEE are much less generous than in their neighbors, even once we accommodate for price differences. Old-age minimum / basic pensions are particularly weak in Romania.

EU27 pensioners are also protected by means-tested social assistance. In table six, we further investigate on protection effectiveness against poverty risks. We conclude that, in spite of weak pensions, early 2000s poverty risks were beneath EU15 in Czech Republic, Hungary and Slovenia; these poverty risks were close to countries like Finland and Sweden. Poverty risks in other CEE are generally close to
EU15 average. Yet poverty risks for women after 65 is considerably higher in Bulgaria, Latvia and Lithuania, where it is around 17%. Furthermore, as recent reforms increase benefit individualization, they may increase poverty risks for workers with irregular careers (EC, 2006c).

Table 6. Poverty Risks and Minimum Pensions in EU27

<table>
<thead>
<tr>
<th>2006 Minimum / Basic Pension (Euros, PPP)</th>
<th>Early 2000s poverty risks (at 50% national income threshold)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>Average</td>
</tr>
<tr>
<td>&lt;4000 Czech R, Hungary, Poland and Slovenia</td>
<td>Bulgaria, Estonia, Latvia, UK</td>
</tr>
<tr>
<td>[4000, 8000] Austria, Denmark, Finland, France</td>
<td>--</td>
</tr>
<tr>
<td>&gt; 8000 Netherlands, Sweden, and Luxembourg</td>
<td>Belgium</td>
</tr>
<tr>
<td>MTSA only</td>
<td>--</td>
</tr>
</tbody>
</table>

Data sources: Missoc and US-SSA for minimum and basic pension data; Eurostat for PPPS and poverty risks

Poverty protection also depends on effective indexation. CEE pension systems adopt the same four indexation methods as in EU15. The most common indexation method integrates both wage dynamics and price changes. This is World Bank recommended method; it is coherent with EC preference for life-style dynamics indexation. This is yet not the case in Czech Republic, who opted, as most EU15 (table 1), for inflation indexation.

Outstandingly, automatic indexation is very important in CEE. In Bulgaria, Lithuania and Romania, ad-hoc indexation makes pensioner income evolution dependent on external concerns. Indexation is only redistributive in Bulgaria, Latvia, Lithuania and Romania. These favor protection over insurance, while other CEE opt for methods, which apply neutrally the protection and indexation.

2.2.2 Insurance

PAYG pensions are a common feature of CEE and EU15 pensions. As in EU15, the DB arrangement is the most popular, while NDCs have been introduced in Latvia and Poland. No CEE countries adopted a flat-rate PAYG.

Like EU15, private pension coverage varies significantly in CEE. These
differences can only be partly explained by their compulsory nature. Furthermore, private pensions were never compulsory for those over 30-42 (see table six). Private pension coverage is important even where these are voluntary because of significant fiscal incentives.

Chart one portrays CEE net replacement rate evolution since 1989. These show how different pension systems insure pensioners and depict average benefit-contribution link. In some countries, replacement rates increased in the early 1990s, as a result of real wages drop. Yet pensions lost their relative purchasing power rapidly. From the mid-1990s, there was important oscillation, around a downward trend.

Net replacement rates have been lower in Baltic countries, Bulgaria and Romania, where they are close to OECD Anglo-Saxon countries (chart two). Consequently, in Baltic countries working pensioners are more important than in EU15 and people over sixty-five only derive 60% of their income from pensions.

Chart 1. Net replacement rate evolution in CEE, 1989-2005

Sources: Own calculations based on data from national statistical offices and for Bulgaria, Palmer (2007)

---

9 We prefer to use net rather than gross variables, because the fiscal treatment of wages and pensions is not identical – i.e. in some countries, pensions are exempt from taxes and often they have a more favorable fiscal treatment.
Although CEE old-age pension systems average replacement rates are less generous than most EU15 (chart two), except in Poland and Slovenia. PAYG replacement rates are expected to fall even further in the near future. On the one hand, pensioners are supposed to derive an increasing proportion of their income from private funds (be it compulsory or voluntary). On the other hand, ageing and other budgetary pressures also decrease replacement rates.

We can also observe some redistribution in benefit formula. In EU15, replacement rates are higher for lower wage earners in Belgium, Denmark, France, Ireland, Luxembourg, Portugal, Sweden and UK. Among OECD CEE, only Czech and Latvian benefit formula are redistributive. Conversely, contribution-benefit link is particularly important in private pensions. Among PAYG arrangements, *individualization* is the most important in NDCs.

Generally low net replacement rates (and beneath EU15 average levels) emerge from the composition of different (but certainly not independent) processes:

i) A path dependent (low) pension generosity, since replacement rates were indeed lower during central planning;
ii) The liberal ethos of systemic transformation, favouring individual responsibility and social spending cuts;

iii) New values associated with privatisation legitimate substituting PAYG pensions with private pensions (be them compulsory or voluntary);

iv) The composition of different pressures calling for restrictive policies (EU, IMF, World Bank as well as national actors); and

v) The strengthening of Finance Ministries relative to social affairs ministries (Müller, 2003) favours both the development of private pensions and PAYG pension reduction.

2.2.3 Financial sustainability\textsuperscript{10}

In spite of an important diversity on old-age pension systems, EU15 pension expenditures (as a proportion of GDP) are rather similar and tend to be above nine percent. Except for Poland and Slovenia, pension expenditure represents a smaller proportion of GDP in CEE. This is the outcome of lower minimum pensions and inferior replacement rates.

From 1995, pension spending as a proportion of GDP have generally been stationary both in CEE and in EU15. Yet this ratio declined in Ireland, Estonia and Latvia. It has increased in Czech Republic.

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|}
\hline
\hline
\textless 9\% & & \textbf{Czech Republic} & \textbf{Bulgaria, Hungary, Lithuania, Romania and Slovakia} & Ireland, Estonia and Latvia \\
\hline
[9,12]\% (*) & & Belgium, Germany, Greece, Portugal & Denmark, Finland, Netherlands, \textbf{Poland, Slovenia}, Spain, Sweden, and UK & Luxembourg \\
\hline
\textgreater 12\% & & & & France, Italy and Austria \\
\hline
\end{tabular}
\caption{Pension spending as a proportion of GDP since 1995}
\end{table}

(*) EU15 average for the same period represented 10 to 11\% of GDP.
Source: Eurostat

Although EU enlargement was expected to foster social spending, no such growth occurred in pension spending (as a proportion of GDP) apart from Czech

\textsuperscript{10} In this section, we analyze pension expenditure data. Although old-age pensions represent the major share, these also include survivors and invalidity pensions. We should bear in mind particularly that throughout CEE invalidity pension expenditures grew during the 1990s.
Republic. Such an EU effect was supposed to come from partner emulation, since public pension expenditure levels are higher in EU countries than elsewhere; this “reflects differences in the public/private mix of provisions and in the benefit levels and the effective retirement age in the public systems” (Holzmann, 2004).

Yet, EU spending dynamics should be historically contextualized. In the Rome treaty group, social spending upsurge was stirred by economic growth and, from the 1970s, by crisis. The situation in CEE is different. Here, early 1990s pension increase was a consequence of transformational crisis coupled with employment informalization. Accession increased demands for fiscal restrictive policies; e.g. 2004 broad economic policy guidelines (EC, 2004a) were dominated by general deficit concerns. Furthermore, although they are required to adopt the euro, most CEE countries are far from Maastricht criteria (apart from Slovenia, Estonia and Latvia).

National spending variations can be linked three factors: the first are transition costs following systemic reforms; the second is protection and insurance diversity; the third are differences in the number of pensioners.

All countries introducing compulsory private schemes experience transition costs. Transition costs depend directly on compulsory private pension coverage. Transition costs threaten system stability even in countries where pension spending remained low, such as Latvia and Estonia. In Estonia, contribution rates were increased and a reserve fund established; yet, the fund rapidly exhausted. In Hungary and Poland, pension system deficit was aggravated by transition costs. In Slovakia, privatization revenues will be mobilized to cover transition costs as high as 1% GDP.

The protection and insurance differences we analyzed previously also explain spending differences. Decreasing pension spending in Estonia and Latvia results from lower replacement rates and low minimum pensions. These partly financed transition costs. Yet, Bulgaria and Romania, with replacement rates and minimum pensions similar to those countries, could not decrease pension spending, because their employment rates are considerably lower (vide chart three).

The number of pensioners is the last determinant of pension spending. Unlike EU15 countries, where ageing derives from low fertility rates combined with long life expectancy, Baltic, Bulgarian and Romanian life expectancy remains low. In these countries, the main demographic problems affecting contributions are very low fertility rates combined with emigration. In other CEE countries, the demographic pressure is more important, since low fertility and emigration (which cut-down on the
number of contributors) combine with ageing (which multiplies the numbers of beneficiaries).

Throughout EU27, pension reforms strive for dependency ratio redressing, through retirement entitlement age increases and through incentives to retire late and sanctions to early retirement. In the same aim, the Stockholm European Council established employment rates for workers aged 55 to 65 should reach 50% by 2010.

In most CEE retirement entitlement age has been increased, but remains inferior to EU15. Although entitlement ages are very different, as a rule effective retirement takes place very early in Lithuania and Slovenia (both sexes) and for Slovakian women. On average, Latvians and Estonians are among EU27 later retirees. Among men, Czech and Bulgarian men retire at 62 (EU average), while Hungarians and Slovaks retire on average one year and a half before (but still later than EU27 earliest retirees, Belgium and Luxembourg).

Average effective retirement takes place before entitlement in most countries and after entitlement in Latvia and Estonia. Although early retirement is possible in all CEE, it is not identically expressive in all of them. During the 1990s, early retirement was particularly important in Bulgaria, Hungary, Poland, Slovakia and Slovenia. It is still an important issue in Poland and Romania. Early retirement had significant consequences on employment rates for workers over 55.

Chart three shows employment rates for workers aged 55 to 64. While most EU15 countries are only entitled to retirement after 65, workers in all CEE countries can legally retire from 62-63. This, along with early retirement, explains lower 55-64 employment rates in Poland, Slovakia, Slovenia, Hungary and Bulgaria. While these employment rates have been increasing in most countries, they continued to contract in Poland and, more importantly, in Romania. These represent an important budgetary weight for these countries. Although, by 2005, Czech Republic, Lithuania and Latvia were better than EU15 average, they had not yet reached the Stockholm Council 50% target. Estonia was the only CEE country, which, along with Sweden, Denmark, UK, Finland, Ireland and Cyprus already reached this goal.

Confronted with low employment rates, aggravated by pension transition costs, CEE countries have kept contribution rates high. While 2002 EU15 contribution rates are as low as 16% in Belgium, France and Luxembourg, in CEE they range from 23%

---

11 All data on effective retirement age, 2001 to 2005, are from Eurostat.
(Bulgaria and Estonia) to 35% (in Romania, which is the same as Portugal). These have been reduced in some countries (e.g. Latvia and Romania in 2004).

Chart 3

![Graph showing employment rates for workers 55 to 64 years old]

Sources: Eurostat
### Table 8 – CEE Protection, Insurance and Financial sustainability (2004-06)

<table>
<thead>
<tr>
<th></th>
<th>Protection</th>
<th>PAYG</th>
<th>Private Pension funds</th>
<th>Spending % GDP</th>
<th>Effective Age</th>
<th>Demographic trends</th>
<th>Fin Sustainability</th>
<th>55-64 N rates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>DB</td>
<td>DC</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Czech R</strong></td>
<td>High</td>
<td>↓ &gt;1993</td>
<td>Low</td>
<td>High Vol T incentiv</td>
<td>Low ↑; deficit</td>
<td>Average</td>
<td></td>
<td>Average ↑</td>
</tr>
<tr>
<td><strong>Slovenia</strong></td>
<td>Average</td>
<td>Average</td>
<td>→</td>
<td>High Vol T incentiv</td>
<td>Average</td>
<td>24,35</td>
<td>Rapid Ageing</td>
<td>Very low but ↑</td>
</tr>
<tr>
<td><strong>Hungary</strong></td>
<td>High</td>
<td>Low</td>
<td>→</td>
<td>deficit TC</td>
<td>Low</td>
<td>26</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Slovakia</strong></td>
<td>Low</td>
<td>Low Comp</td>
<td>High TC</td>
<td></td>
<td>28</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Bulgaria</strong></td>
<td>Men- Aver; W: Very low</td>
<td>Very low</td>
<td></td>
<td>High Comp.</td>
<td>Low → Average</td>
<td>23</td>
<td>Low life expectancy; Low fertility</td>
<td>Very low ↓</td>
</tr>
<tr>
<td><strong>Romania</strong></td>
<td>High</td>
<td>Average</td>
<td>Aver Comp.</td>
<td>High TC</td>
<td>Low</td>
<td>32,52</td>
<td>Ageing DRF</td>
<td></td>
</tr>
<tr>
<td><strong>Poland</strong></td>
<td>High</td>
<td>Average</td>
<td>Aver comp; low vol</td>
<td>Surplus</td>
<td>High</td>
<td>20 +fee</td>
<td>Low life expectancy; Low fertility; (&lt;Stockholm)</td>
<td>Average ↑</td>
</tr>
<tr>
<td><strong>Latvia</strong></td>
<td>Men- Aver; W: Very low</td>
<td>Very low</td>
<td>Aver, coverage</td>
<td>Mix Low TC</td>
<td>Low</td>
<td>26,1</td>
<td>Low life expectancy; Low fertility; moderate ageing</td>
<td>High; (&gt;Stockholm)</td>
</tr>
<tr>
<td><strong>Estonia</strong></td>
<td>Average</td>
<td></td>
<td>High compuls; low vol</td>
<td>TC reserves exhausted</td>
<td>High</td>
<td>22</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Legend:* ➞ stable; ↓ decreasing; ↑ increasing

Comp- Compulsory private pensions; DFR – declining rate of fertility; T incentives – tax incentives; TC – Transition costs; Vol – voluntary private pensions;

*Note:* Protection, Insurance and financial stability levels are established confronting EU15. In this sense, Low means inferior to EU15, High means superior to EU15 and average means close to EU15 average.

Table eight synthesizes our discussion on section 2.2. It is important to note that protection is effective in all countries, although risks of poverty for women are high in some countries. Table eight highlights a trade-off between pension replacement ratios and fiscal situation. While, except for Poland and Slovenia, pension spending is kept beneath EU15 average, CEE pensioners earn pensions that fare worst to net wages than their EU15 neighbors. This is particularly true for Latvia and Estonia, who fare very well in fiscal sustainability, but have very low replacement ratios, close to UK and Ireland.

Furthermore, financial situation does not depend strictly on pension design. Although Poland and Latvia have similar pension systems, they face very different budget situations. Poland, Slovakia, Slovenia, Hungary and Bulgaria face important difficulties in promoting older worker employment rates.
2.3 Confronting CEE and EU15 old-age pensions

Tables five and eight underline CEE old-age pensions diversity. They also highlight no reform conformed strictly to the World Bank (1994) three pillar proposal; none emulated an exiting EU15 model neither. We sustain emerging old-age pension systems in CEE recombine national legacies, World Bank propositions as well as elements taken from reforms carried out in EU15 countries and EC propositions.

Emerging systems are diverse and hybridize components from different archetypes. We can identify four major processes influencing national-level recombination.

The first process derives from World Bank financial support and technical advice. Czech pension system situation isolated it from World Bank advice. Elsewhere, governments knew bank support was dependent on private compulsory fund introduction, while PAYG reforms options were left open (Müller, 2003). In this sense, conditions on second-pillar were strict, while first pillar setting was loose. Although a majority of CEE introduced a compulsory private pillar, all kept a reformed public PAYG insurance, which absorbs at least two thirds of total contributions. This is different from the Chilean three-pillar model, where the public pillar is excluded from insurance, and is closer to the Argentinean model.

This opened the door to a second process, marked by public system path-dependent evolution. While private compulsory finds were imposed top-down, PAYG reforms were the most discussed (Müller, 2003). PAYG reforms were influenced by national legacies, including low replacement rates and low entitlement ages. This path dependent evolution was clearly not a linear process and it was influenced by the ideology of transformation. Economic transformation had a strong feedback effect of socio-cultural values and increased the positive appeal of individualization and privatization. It legitimated stronger benefit individualization and pension privatization.

Rather than the Argentinean model, Hungarian reforms became a focal point for other CEE countries (*idem*). The emulation of the Hungarian model marks the third process. Most CEE old-age pension reforms include a reformed PAYG insurance and a compulsory private pillar. Within this group, Latvia and Poland introduced a
specific recombinant system, where reformed PAYG was converted into NDC. These, as we have argued before, hybridize PAYG functioning and a DC benefit determination, imported from private fund benefit determination. Hungarian reform model, recombining public unfunded DB and private funded DC was also applied in Bulgaria, Estonia and Romania.

Lithuania also developed a particular system. Here, private funds remain voluntary. Yet, to those who decide to adhere to them, contributions will be taken out of the normal contribution to the pension system. This hybrid system recombines public unfunded DB, a voluntary private funded DC and contribution sharing principles.

The perspective of EU enlargement dominated a forth process. While specific features were emulated, no EU system was copied. Although Latvian and Polish pension reform emulated the Swedish model, none implemented a universal system. Thus in these countries, NDCs induced individualization is strengthened by the moderate solidarity. Expectations on pension reforms were also important. For example, Hungarian government presented private compulsory funds as the future of EU old-age pension system (Müller, 1999).

Another important constraint from EU integration was the prominence of fiscal concerns in broad economic policy guidelines and the need for euro adoption, EU accession might have prompted for pension spending contraction rather than expansion. What’s more, the EC insists on the need to promote funded systems and EC appreciations on reforms are more sympathetic towards systemic reformers.

Czech Republic and Slovenia are the closest to EU15 countries. Yet both these systems are hybrid and result from local articulation.

Czech Republic was a CEE pioneer in private pensions. While participation is voluntary, employment coverage is high. Participation is encouraged by both fiscal incentives and low PAYG replacement ratio. In official discourse, V. Klaus’s liberal doctrine opposed compulsory private pensions and favored bottom-up private pension development. Czech private fund coverage makes these important actors and increases voices favoring compulsory private pensions. Furthermore, EC recommendations consider Czech pension system unsustainable.
The conditions of Slovenian reform are different. Actually, Slovenian Ministry of social affairs envisaged adopting compulsory private pensions. Yet, its Ministry of Finance considered it would involve excessive transition costs and consistently opposed such a reform. This configuration is opposite to the common preferences of these ministries in other countries (Müller, 2002; 2003). Voluntary private funds were introduced instead.

Thus, national reforms recombined existing pension models. Recombined models include legacies, the three pillar model, DB PAYG and DC private pensions. The process of hybridization was institutionally embedded and structured by the ideology of economic transformation and cognitive Europeanization.

Table eight shows significant protection, insurance and financial stability diversity across CEE. It also reveals similar reforms entailed divergent situations. Among the biggest group, which combines BD PAYG and compulsory private pensions, there is also important diversity. Protection is not higher in universal systems. Financial sustainability is compromised both by low employment rates and by considerable transition costs.

Latvia and Poland both have non-universal NDCs with compulsory private funds. Nevertheless, Poland has a more effective protection and higher replacement ratios with lower older worker employment rates and ageing that is more important. These differences have critical consequences on pension spending.

Slovenia and Czech Republic are also very different although they both opted for combining voluntary private pensions with a non-universal PAYG. Although Czech protection is more effective, replacement ratios are lower and decreasing. This combined with more important and increasing older worker employment rates resulting from higher retirement age and higher contribution rates, allow Czech Republic a lower level of pension spending, which has been increasing.

Intra-CEE diversity results from different reform strategies but also from different labor market situations. Protection effectiveness and replacement ratios depend clearly on a longer trend. Baltic countries are actually closer among each other than vis-à-vis countries having opted for similar reforms. This proximity can be explained, for example, by a similar fiscal discipline, making fiscal subjects prominent over social policies. In the Baltics, transition costs were lower and financed at the expense of lower protection and lower replacement ratios. Therefore reform
application is embedded in path dependent processes. Reforms are recombined with national traditions.

Relative to EU15, CEE countries have high to average protection, with different replacement rates and generally lower retirement ages. Financial sustainability conditions are very different across CEE. Although older worker employment rates are a problem to a considerable group among CEE, spending remains beneath EU average.

**Concluding remarks**

The ESM is difficult to define. We have considered this difficulty in the field of old-age pensions. If we deduce the ESM from EC documents, then we should underline the need for protection and for funded systems. EC recommendations give the state an important role both in insurance and protection provision and in private pensions supervision. If we consider the ESM is the minimum common denominator between EU15 old-age pension systems, we are confronted with important diversity, which imposes a rather vague definition of the ESM, based on minimum or basic pensions, indexation and important public PAYG systems. This paper underlined national pension systems emerged recombining public and private pensions with legacies.

Relative to World Bank pension reform proposals, the ESM is more state-friendly. Although World Bank approach has evolved and embraces national latitude, the ESM is more favorable towards NDCs and tolerates higher NDCs. Both approaches focus on universal means-tested protection and living standards indexation. Both these approaches were recombined by CEE old-age pensions reforms with their legacies in an institutionally embedded process.

If we confront CEE with these principles, we can conclude there is some affinity. Yet, we may formulate two remarks. Firstly, the principles we have established are rather vague, since EU15 divergence is important. Secondly, CEE old-age pensions may increase EU27 heterogeneity, since the hybridization of existing models introduces novelty.

CEE pension protection is frequently means-tested and poverty risks are low to average relative to EU15. Yet, poverty risks are higher form women in certain countries and endangered by increased individualization. Price and wage indexation dominates. Diversity is higher in insurance, although compulsory private pensions
were dominant. Baltic countries, Bulgaria and Romania combine private compulsory pillars with very low replacement ratios. Czech, Slovakian and Hungarian replacement ratios are only slightly higher, while Slovenia and Poland are closer to EU15 average. Pension spending as a proportion of GDP is clearly influenced by replacement ratios as well as formal employment dynamics and by transition costs emerging from privatisation. Restrictive budget policies influenced pension reforms; although Ministries of Economy often favored privatization, in Slovenia, transition cost estimation became an argument against it.

Cited References


EC (2006a), Portfolio of Overarching Indicators and Streamlined Social Inclusion, Pensions, and Health Portfolios, Employment, Social Affairs and Equal Opportunities DG.


EC (2005), Working together, working better - A new framework for the open coordination of social protection and inclusion policies in the European Union, COM/2005/0706 final - Communication from the Commission to the Council, the
European Parliament, the European Economic and Social committee and the Committee of the Regions.

EC (2004), Increasing the employment of older workers and delaying the exit from the labor market, COM(2004) 146 final, Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee Of The Regions.

EC (2004a), The 2004 Update of the broad economic policy guidelines (for the period 2003-05), Directorate General for Economic and Social Affairs.


