Pension Reform in the New EU Member States –
Will a 3-Pillar Pension System Work?

by

Helmut Wagner

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1. Background to pension reforms in the NEW-8

The new EU member states in Central and Eastern Europe (NEW-8) started in the early 1990s with a daunting legacy. The public pension schemes were structured along socialist principles, and contributions were collected from employers (often at flat rates based on the wage bill). This led to an immense challenge in the transformation process.

Main features of Pension Systems in the Mid-1990s were:
(i) High system dependency ratios
(ii) Low retirement age
(iii) High replacement ratios (in some countries)
(iv) Unfavorable demographic trends and growing financial imbalance
   (Dramatic decline in birth rates; increasing life expectancy, danger of labor emigration)
(v) High contribution rates, weak link between contribution and benefits, and limited incentive to comply
(vi) Significant intra-generational and inter-generational inequalities.

Furthermore, underreporting of wages became widespread, implying a drop in revenues, and requiring state subsidies.

The financial pressures from the transition to market economies have had a major impact on pension reforms in the NEW-8. For example, mass redundancies in the process of restructuring the former state enterprises left little alternative to large-scale early retirement, at a high cost to government budgets.

However, the financing problem was not just confined to the expenditure side. People acquired pension rights on the basis of their work record, while financing was based on payroll taxes levied at company level. Thus there were no effective links between rights and contributions at the individual level. In a situation with falling employment, a growing shadow economy and major difficulties in collecting social insurance contributions, the old system of financing and of acquiring pension rights could not be sustained as it produced major deficits in their pension and social protection funds.

Individual accounts with stringent and transparent links between individual contributions and the build-up of benefit rights seemed to offer an attractive solution to the problems of the NEW-8. Furthermore, as capital formation in the economy was insufficient and the need for investments in all areas was massive, the idea of pre-funding a part of future pension provision became attractive also from a macroeconomic perspective. However, against the

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1 Professor of Economics, University of Hagen (Germany). This is a draft, written in the context of advisory service that the author has carried out for the IMF Fiscal Affairs Department during his stay as consultant of the IMF in spring and summer 2004. It is based on a survey of the literature and on interviews with experts from various NEW-8 countries in international organizations. The author is grateful to Jürgen Ehler, Eva Peilert and Konrad Stockmeier for research assistance.
diverse historical and political background in the individual NEW-8 states, these countries have decided to go their own, i.e. various, ways in reforming their pension systems.

2. Pension reform process in the NEW-8

Over the last decade, pension reform has been a major issue on the political agenda across Europe. In the EU-15, changes in pension schemes have primarily come in response to current and prospective population aging. However, population aging is also one of the most pressing future problems in the NEW-8 (see Figures 1 and 2 in the Appendix). Through increases in pension and health-care expenditures, population aging is expected to have a negative impact on the medium and long-term fiscal sustainability. This is one of the major fiscal risks in the NEW-8 as pension and health-care spending are in many countries the biggest single items among all budget expenditures.

When facing this problem, most NEW-8 countries have been adopting parametric changes in their pension PAYG pillars. Their primary objective has been to link pension benefits closer to pension contributions and to bring the unfunded public scheme closer to actuarial balance. The measures include cuts in pension benefits, increase in retirement age, increase in pension contributions or a combination of those.

2.1 The Status quo in the NEW-8’s pension reform process

With respect to their pension reforms, the NEW-8 form three clusters:

1. Latvia, Poland, Estonia, Hungary and most recently Slovakia have adopted major changes and introduced a second pillar of mandatory, fully funded, privately managed schemes.
   Latvia and Poland have furthermore introduced a new first pillar based on the principles of Notional Defined Contribution (NDC).
   (Latvia was the first to set up a pillar informed by the NDC principles developed in Sweden. But it took a while before it added the fully funded second pillar element and a voluntary third pillar supplement. In Poland, first pillar reform and the introduction of a funded 2nd pillar happened simultaneously.3)

   Estonia has established a PAYG defined benefit scheme similar to the German, whereas Hungary and Slovakia have reduced their existing first pillar (PAYG defined benefit scheme) to make room for the mandatory, second pillar of private schemes.
   (Estonia did not follow the precedence established by Latvia. The major reform of 1997 changed the first pillar to a PAYG financed, earnings-related scheme similar to the German points based system. Only 5 years later, and as a separate reform step, did Estonia implement a mandatory, fully funded 2nd pillar scheme where savings will be managed by private pension funds. Hungary shifted part of pension provision to a mandatory pillar of private schemes with the 1998 reform. At the end of 2003, Slovakia followed in its footsteps by introducing a similar reform.)

2. By contrast, Lithuania and Slovenia have retained their PAYG defined benefit systems financed from social security contributions and general taxation.
   (Lithuania has implemented some parametric reforms.
   In Slovenia, the government had to withdraw its proposal for a 3-pillar system in the face of massive popular protest. Instead it sought to consolidate the existing system through various parametric reforms.)

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3 See Chlon-Dominczak and Gora (2003) for more details on the Polish way of pension reform.
(3) The **Czech Republic** is located *somewhere between* these two clusters. Early in the transition period it opted for a universal, defined benefit system financed on a PAYG basis without adding a mandatory pillar of fully funded private schemes.

(With the reform in 1993 and the follow-up in 1995 the **Czech Republic** was the first post-communist country to implement a major reform of its public pension system. Yet, policymakers here were more concerned about removing incentives to early retirement and establishing a universal and equitable, defined benefit system financed on a PAYG basis, than about introducing elements of funding and privatization. There is no mandatory funded pillar and the voluntary third pillar is of negligible importance.)

The basic characteristics of the reformed pension systems in the NEW-8 states are summarized in more detail in Tables 1 and 2 in the Appendix. Table 1 describes the current pension systems in the Central European new EU member countries (CECs), whereas Table 2 also includes the other new member states and in addition the development process in the single countries.

2.2 Further steps planned in the short term

**Hungary** intends to increase the first pillar old-age pensions by introducing a 13\textsuperscript{th} month pension gradually over four years. **Latvia** plans to introduce higher indexation of pensions. The objective of those measures is to improve the social situation of pensioners.

In addition to parametric changes, the majority of the countries have introduced a 3-pillar pension system, including a state managed, PAYG pillar and two fully funded pillars (one obligatory and one voluntary). In the 2003 PEP, **Lithuania** and **Slovakia** presented plans to implement a multi-pillar pension scheme (in 2004 and 2005, respectively). The introduction of the second (funded, obligatory) pillar requires a high degree of administrative preparation in order to avoid implementation problems. For instance in Poland, there have been delays in transfers of social insurance contributions from the Social Insurance Institution (ZUS) to private pension funds. In addition, the classification of the second pillar in ESA 95 methodology outside the general government would increase the deficit figures for countries that pursued this kind of pension reform. The main measures in the PEPs concerning pension reform are described in Table 3 in the Appendix.

3. Assessment of the various reform approaches in the NEW-8

3.1 Comparison to the EU-15

**Compared to EU-15**, the statutory **contribution rates** for pensions tend to be **high** in the NEW-8 (typically 25% or more of gross earnings). The resulting **replacement rates**, however, tend to be **low**. This is due to **low employment rates**, particularly for women and older workers, and the **former weak links between contributions and benefits** (the present generations of pensioners with claims under the old pension systems still have to be provided for). In addition, in many NEW-8 countries (such as Slovenia, Poland, Hungary, the Czech Republic and Lithuania), there is a **low average exit age** from the labor market which constrains revenues and raises costs.

As it **will take decades** before benefits from fully funded schemes reach the intended level, benefit adequacy and employment rates will thus continue to be pressing short- to medium-term issues in these countries. As mentioned above, **in the longer term**, the NEW-8 will also face the **challenge of population aging**. This will imply additional spending pressures for
pension schemes. By 2050, on present trends, the new member states can expect to have old age dependency ratios (people aged 65+ as a percentage of people aged 15-64) at around 50%, which will be higher than in the EU-15 (see Figure 2 in the Appendix).

3.2 Pension design clustering in the new EU-25

The main difference from current arrangements in the EU-15 countries is that five of the NEW-8 (as part of their statutory arrangements) have established a second pillar of mandatory, fully-funded, defined contribution schemes in which pension savings are administered by competing private pension funds or insurance companies. Flat-rate, public, first pillar arrangements are rarer in the NEW-8 where pension systems tend to fit either the so-called ‘Bismarck’ or the ‘NDC’ design models (see Table 4 in the Appendix).

Among the EU-15, only Sweden has a system with a mandatory, fully funded element (only a contribution rate of 2.5% versus a rate of 6-9% in the overall provision). Others – the Netherlands and Denmark – have a significant 2nd pillar of fully funded occupational pensions based on collective agreements, and the UK and Ireland rely to a large extent on voluntary funded provision, either through occupational or personal pension schemes (Commission of the European Communities, 2004, p. 29).

The difference in reliance on funded, privately administered elements in pension provision is therefore more one of degree and approach than of principle.5

Enlargement will not bring basic changes to the general objectives of the EU with respect to pension reform: the present EU overall strategic approach to pension reform embodied in the Laeken objectives of adequacy, financial sustainability and adaptation to labor market and societal changes will continue to be considered as appropriate to address the medium and long-term challenges to pension systems in the EU-25. However, pension reforms will continue to remain the area of responsibility of the individual member countries. The differences between pensions in the EU-15 and the NEW-8 are less than it would appear. Moreover, with developments towards a somewhat larger role for funded elements in overall provision already under way in several member states, enlargement is unlikely to lead to a new orientation of the EU coordination on pensions.

Given the present vulnerabilities of pension systems in the NEW-8, the EU process of the Laeken pension objectives would most likely only lead to an extra emphasis on securing the adequacy of benefits, higher employment and longer work lives as core factors in sustainability and effective regulation and sound management of pension funds. Against the challenge of population aging, a major criterion in assessing various pension systems should be which system could best trigger positive savings effects and thus (according to the Laeken objectives) ensure that older people are not placed at risk of poverty and provide access for all individuals to appropriate pension arrangements.

3.3 Future plans and challenges: some fragmentary aspects and assessments

In Hungary, from 2013 the first pillar is planned to be restructured and turned into more of a notional defined contribution system. Furthermore, from 2013 a new benefit formula is

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5In the NEW-8 one would expect a more far-reaching (paradigmatic) nature of reforms. However, reforms there were primarily motivated by practical concerns and inspired by innovations in the EU-15 countries.
scheduled to be used to calculate the pensions by which the relatively generous public benefits are to be pared down and the degree of equivalence strengthened. The official figures are predicated on optimistic assumptions concerning the trend in employment which the OECD regards as unrealistic. The status of the new two-tiers system ought to be clarified. Further development of the Hungarian capital market would also be helpful.

In the **Czech Republic**, further planned reforms are to create an occupational pension fund tier. The Czech ministry of finance predicts that by 2030 alone, contribution rates would have to climb from currently 26% to 44% if the public pension fund is to remain in equilibrium under present conditions. Therefore, there is urgent need of reform.

In their present form, the Czech and the Hungarian pension systems will hardly be sustainable. The strongest sign of this is that the pension contributions in both countries still amount to a very high 26% (for employees with average income). Without the prospect of a substantial reduction in this burden, such contribution rates must sooner or later become a serious obstacle to economic growth. This threatens to lead to a vicious circle, as steady economic growth would in turn facilitate the provision of future retirement incomes. The necessary further scaling-back of public pension systems should be accompanied by redoubled efforts to accumulate private capital for funded pensions. Furthermore, it seems that the notion of a compulsory private scheme in particular is meeting strong resistance in the Czech Republic. On the other hand, membership need not be compulsory if a high degree of coverage can be attained by other means, for example through tax incentives. (Relatively generous tax privileges have been instrumental in making the third pillar a popular success in the Czech Republic and Hungary.)

In **Poland**, the new architecture of pension provision with its relatively strong second pillar may be considered comparatively resistant to demographic shocks. Moreover, given its present condition, the Polish pension fund market in particular should harbor much further potential in the years ahead. In Hungary, too, the pension fund industry can be expected to grow briskly if reforms are instituted without delay. To be sure, growth in pension fund assets is likely to put the absorptive capacity of financial markets in the new member countries to a severe test. Most of all, accession to EMU will trigger a quantum leap. The new member countries’ pension capital will then have access to the large euro area.

In **Slovenia**, changes to a system of voluntary pension insurance may lead to an increase in the number of participants in the system. Further changes also relate to a mixed system of indexation of pensions where pensions are adjusted annually in accordance with the change in average wages per employee.

In general, against the background of the demographic challenge and the socialist legacies (preserving a PAYG-dominated system in most of the NEW-8), it appears that there is no alternative for all the NEW-8 countries to switching to a multi-pillar pension system and to fostering the second and third pillars. (The most serious challenge for most of the NEW-8 is ensuring a move away from a PAYG-dominated system, a move which has been delayed by close to a decade.) But in some countries it may take longer, because of mainly politico-economic hindrances (pointed out in section 5 below); and the specific regimes in the individual countries may eventually be different. The latter, however, need not matter, as there is no optimal system solution for all NEW-8 countries. We shall discuss this in the following section.
4. Pros and Cons of various pension systems

4.1 One pillar versus multi-pillar system

A one-pillar system is the traditional PAYG-system. A PAYG system is based on inter-generational transfers while a fully funded (FF) system is based on saving. PAYG schemes pay pensions out of current contributions or taxes. They are in danger of becoming massively under-funded when the number of people drawing pensions begins to markedly increase relative to the number in the active labor force paying into the systems. Furthermore, the PAYG payroll tax imposes an excess burden on workers that tends to result in a reduction of labor supply.

An alternative one-pillar system would be full privatization, for example. Full privatization offers the opportunity of swift and consistent restructuring of retirement provision. This can generate a strong impetus for savings and the development of financial markets. However, the preconditions for quick expansion of these markets must exist or be created.

Privately funded FF pillars are expected to help diversify assets and thereby to ease the burden of impending population aging thus shifting a segment of contributions out of the PAYG system while payment obligations from the pre-reform system remain intact. Furthermore, it is hoped that replacing PAYG systems with FF systems increases labor market efficiency, spurs domestic capital accumulation, and counteracts rising dependency ratios. However, the theoretical and empirical evidence of these effects is ambiguous. It is argued that benefits from increased capital market efficiency may not materialize in a small open economy where domestic investment is independent of domestic saving (see Schimmelpfennig, 2000). The main disadvantage of full privatization may be seen in excessive risk-taking.6

In contrast, partial privatization implies that a PAYG tier is retained in a modified form: The public system is downsized, and complemented by the creation of occupational pension funds (as in the Netherlands, or in Switzerland). Neither approach is intrinsically better than the other. In gradual privatization, the above-mentioned problems are less serious. Moreover, the aim of risk diversification makes a balanced three-pillar architecture desirable, while the public systems are subject primarily to the threat of political intervention, funded systems entail the risk of unsatisfactory investment returns.

Partial privatization is part of a multi-pillar pension system. A 3-pillar system (as suggested by the World Bank, 1997, cf. Holzmann, 1997) is structured as follows: the first pillar is PAYG and provides a minimum pension, the second pillar is FF and mandatory, and the third pillar is FF and voluntary.

The new second pillar is the centerpiece of the pension reform for example in Poland. Private savings are there accumulated in personal accounts kept at private pension funds. Membership is compulsory for all employees born after 1969 (see Table 2 in the Appendix). The funded

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6 The large transaction costs, difficulties of regulating private providers, lack of sophisticated financial education even in advanced countries, and existence of efficient public trust funds have led some observers to raise doubts regarding the widely suggested private management of the second pre-funded pillar (see, e.g., Holzmann and Stiglitz, 2001).
pension plans are run on the defined-contribution principle, i.e. the amount of benefits paid depends solely on the amount of contributions and the realized return on investment. Only at the disbursement stage are the pensions taxed.

The compulsory pension fund system appears to be very popular with Poles. However, there is need for further reform in Poland, too: There are considerable payment arrears, and there is still a host of inactive accounts to which no contributions have ever been credited. Conversion of the first pillar into a lean defined-contribution system would satisfy the demographic imperatives more effectively. The major problem is the financing of the transition process from one system to another. This is associated with high transition costs that have mainly to be carried by the current generations. Hence, opposition to such reforms is to be expected.

There is no doubt that the PAYG system offers a much lower rate of return than the capital market does. However, this may just be the mirror image of the introductory gains of older cohorts. It may be impossible to design a Pareto improving transition to a funded system.

The PAYG system imposes a burden on later generations; however one may claim that any pension system is a zero-sum game for all the generations participating in the sense that the present value of all contributions equals the present value of all pensions.

Funding might still be advisable, because of sharp increase in the old-age dependency ratio. In the PAYG system, people expect to receive a pension from their children, but, as there are not enough children, this implies a double burden: raising children and paying for the old.

The above argument, however, can only lend support to partial funding. In other words, funding with real capital is needed only to the extent that “funding” with human capital is lacking. One should ask those who have saved on human capital to use their funds to provide real capital instead.

4.2 ND- versus NDC-model

Some NEW-8 countries have introduced (or are planning to introduce) a modern three-pillar system in which they also overhaul the traditional first pillar. An example is Poland.

In Poland, the new first pillar is based on the so-called “notional defined contribution” (NDC) model, a PAYG system. Its basic principle is to make the PAYG approach work more like private funded systems with strict equivalence of contributions and benefits. Above the minimum pension, the amount of individual’s NDC pension essentially depends only on the level of contributions made per year to personal retirement accounts (added “Demographic Reserve Fund”). This permits the efficient countering of financial bottlenecks.

Participation is mandatory for all employees born after 1969.

The NDC model implies that an individual notional (unfunded or virtual) account is established for each worker. NDC retirement benefits are then directly linked to the size of these national accounts at the time of retirement. NDC schemes are designed to reward those who remain in the labor force for more years and to penalize those who retire early.

They are expected, in the long run to help keep pension benefits in balance with available payroll contribution revenues. They are contended to be more transparent, less vulnerable to political risk, and more likely to contribute to the development of financial institutions.

A major strength of NDC relative to FF allegedly is that it puts pension benefits at less financial-market risk. This is supposed to make it possible to do so in a way that spreads the economic burden evenly over more generations of workers, to have lower administrative costs and to be less vulnerable to various forms of corruption in comparison to FF, and to be more suitable for nations that do not have well-developed financial institutions and capital markets.
These are theoretical beliefs of the protagonists of the NDC model that have not yet been proved empirically.

One of the major criticisms of the NDC approach is that the assets in the NDC accounts are not capital assets. Moreover, a shift may result in greater income inequality among retirees. In addition, women may be at risk, and a NDC system may shift some risks from the government to individual contributors.

Another critical point of the NDC system is the allegedly high administrative costs of privately managed, defined contribution accounts (“individual accounts”) and the costs of annuitizing accumulated assets upon retirement. In addition, the recent global financial crises have focused attention to the problems of income security under individual account systems (see Holzmann and Stiglitz, 2001). Furthermore, even though one may argue that a NDC system makes parametric reforms (necessary to stabilize the PAYG pillar) easier as it exposes the trade-offs and clarifies concepts, this does not change the macroeconomics of PAYG systems and therefore does not substitute for the introduction of pre-funded second and third pillars. NDC can be implemented as individual account systems, however can also be mimicked by a set of rules in a conventional defined benefits PAYG system, as the proposed new German public pension system exhibits.

However, both, the NDC and FF pillars may be unsuitable for many low-income nations if these countries do not have the administrative capacity to collect contributions, to keep track of those contributions, to communicate, and to pay benefits when they are due. In most NEW-8 countries, however, these capacities are or will likely be soon available so that a NDC system, supplemented by privately pre-funded pillars, appears to be a workable and appropriate approach for most of these countries.

5. Political economy aspects of implementation

In this section, I shall (i) speculate about “what explains the pension reform choices of the NEW-8” described above, (ii) give a personal assessment on the question “Does it make sense for individual NEW-8 countries to switch to a multi-pillar system?”, (iii) express some fragmentary explanations of the politico-economic motives behind the various reforms and non-reforms in the individual NEW-8 states.

I can here only stress a few of the relevant aspects and cannot refer to all NEW-8 countries in the same details. In general, one can say that the main causes for the different pension reform choices made by the individual NEW-8 countries are a mix of different traditions (cultures), legacies, geographic (language, historical) closeness, common values and attitudes, and, last not least, political contingencies. I would support the hypothesis that, in the medium run, all the countries will (have to) move toward a multi-pillar system (convergence) which, however, may be different in detail in the single cases (see below).

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7 However, this and other aspects also refer to FF systems.
8 See Börsch-Supan (2003).
9 Another limitation of the NDC model is sometimes seen in that it is less likely to assure adequate pension benefits for women, low-wage workers, and other workers with irregular employment histories. Furthermore, Orszag and Stiglitz (2001) present 10 myths they believe are present in many discussions of individual accounts.
5.1 What explains the choices of the NEW-8?

Possible explanations of these individual choices are the following ones.

(1) Slow economic growth has worked against the proliferation of voluntary schemes in some new EU member countries (e.g., Poland and the Slovak Republic).

(2) Small populations and undeveloped financial markets have discouraged private companies from starting funds (e.g., Lithuania).

(3) In some countries, tax incentives for voluntary savings have proven effective, though costly, in encouraging their development (e.g., Slovenia). The Slovenian pension system has three pillars. The second pillar is a collective and individual pension scheme (since 2000) that has strong tax incentives.

(4) High administrative costs of individual accounts have led some governments to promote occupational arrangements in which employers contribute to the scheme and oversee its operation (e.g., the Czech Republic). In many countries such arrangements have proven to have stronger management and higher yields than individual savings schemes in which employers play no role. Moreover, such schemes add to the bundle of conditions subject to collective bargaining and thus may help improve benefits and extend coverage. In addition, occupational pensions often feature forms of governance that allow workers and employers to manage the schemes jointly.

(5) In the Czech Republic, and Slovenia, the privatization of their public pension schemes has been vigorously debated along lines adopted by other countries. In each case, the government’s decision to forego this option was based in part on recognition of the high transitional financing costs of moving from PAYG to advance funding of pensions. In the Czech Republic and Slovenia, the government’s posture has also been influenced by strong opposition from trade unions, who perceived pension privatization as undermining the public social insurance system. In addition, as both countries had relatively low levels of external debt, they may have been less open to the influence of international financial organizations that favor privatization strategies (see Mueller, 2002).

(6) Political considerations may explain why policymakers in the CECs have demonstrated varying degrees of willingness to introduce a mandatory private pension provision. In the Czech Republic, legislation approved in the late 1990s and early 2000s envisaged the creation of second pillar pension funds, however the mandatory nature of pension contributions to private funds was then abandoned in January 2002 by parliamentary decision (of the leftist parliament). Among the Visegrad countries, the Czech Republic so far has done the least to reform its pension system. The main problem lies in an insufficient reform of the state PAYG system, which has remained fairly generous. Pensions are being indexed to a rise in nominal wages, which in past years has outstripped inflation. Under the legislation adopted in the late 1990s, employees became obliged to contribute to private pension plans. However, as said before, parliament in January 2002 abolished the mandatory nature of these contributions. Employees of all age groups are now free to decide whether they want to join second pillar funds or not.

(7) Slovakia is a late starter among the CECs. But eventually it succeeded in implementing significant reforms. However, Slovenia is still behind. Slovenia can be regarded as an example of the gradualist approach toward reform of the social protection system. This
applies only to the final result, however, as the initial proposals for the most recent reform were anything but gradual. The “White Paper” which appeared in November 1997, contained quite radical proposals for a fundamental restructuring of the pension system: a large downsizing of the first (public) pillar and the introduction of a mandatory, privately fully funded, second pillar. The reform proposals were obviously strongly influenced by the solutions favored by the World Bank. However, because of strong opposition from various groups – trade unions, some political parties, and influential economists – the original proposals were watered down considerably.

(8) After 1989, new pension programs have been assumed to follow the ‘neo-liberal’ recommendations by international organizations (recipes proposed especially by the World Bank). However, this influence has been largely filtered by past institutions, and by systems adopted in other European countries (already part of the EU).

(9) Poland is assumed as the example of a country that after the fall of the Communist regime introduced a system in line with the model proposed by the World Bank (but concretely influenced by Sweden). In contrast, the Czech Republic is sometimes defined as a case of reforms through which the old-communist model deviated towards (or came back to) Bismarck.

(10) In Latvia, as the example of the Baltic region, the pension program inherited from the Soviet Union was reformed in line with the Scandinavian trajectory. In Estonia, the institutional architecture is typically multi-tier, and private companies play a much more relevant role if compared to Latvia. Lithuania is closer to the Bismarckian model: the supplementary schemes are voluntary instead of mandatory. For a detailed analysis of the (differences in the) Baltic pension reform programs see the recent OECD study (OECD, 2004).

(11) The “Bismarckian family” includes the Czech Republic, Slovakia, and Slovenia. Pensions there are fundamentally related to the original German imprint.
The “Nordic family” includes Poland, Hungary, and the Baltic states. Here, the pension system is largely based on the public earnings-related programs. The Nordic system is hugely based on the first pillar that represents the major source of income for pensioners, while occupational schemes are voluntary (instead of mandatory), and less developed (especially in Finland, the Baltic countries, and Poland).

5.2 Does it make sense for the individual NEW-8 countries to switch (or stick) to a multi-pillar system?

The following assessments can only be fragmentary against the background that the NEW-8 countries are different in various aspects.

(1) Many economists argue that the macroeconomic benefits of a multi-pillar pension system architecture are not warranted. There is insufficient empirical evidence to prove that switching to a privately managed funded pension scheme leads to a rise in economic growth. Economists point out that its impact on savings and investment will likely depend on other macroeconomic parameters.

(2) The Polish experience shows that managing a system of national accounts is not easy, and at the initial stage may become a headache for the public sector. Due to difficulties in
launching a centralized IT system and in identifying individual pension accounts, the Social Security Institution (ZUS) has run a large debt to the Open Pension Funds (OFEs).

(3) In the Czech Republic, the current pension system does not guarantee that in the future the private sector will to some extent assume the pension liabilities to the employed, which are currently fully shouldered by the state. However, the number of participants in private pension funds is high: as of the end of the first quarter in 2003, 54% of the total workforce were members of private pension schemes. The government has recently considered a fiscal reform package that includes a less generous method for indexing the current PAYG pensions, stricter rules for early retirements and the introduction of notional accounts. The reform draft also proposed hiking the minimum pension age to 63 years, but only very gradually, over a decade or more. All of these changes concern only the first pillar of the pension system – the state pension fund. It is still unclear if the government will try to go further and make participation in private pension funds mandatory for at least a part of the labor force. This will depend on political majorities in the parliament.

(4) Given that establishing a second pillar involves substantial administrative costs, potential fiscal benefits of private pension schemes should be weighted against these costs in each particular case. Empirical evidence of the economic impact of switching to the multi-pillar pension system is still scant. From a macroeconomic prospective, it is often argued that the only pension reform measure that is unambiguously beneficial for economic growth is raising the minimum retirement age.

(5) It seems that by revamping their pension systems, Poland and Hungary have reacted in a timely manner to worsening demographic trends and prevented a ballooning of government deficits and an accumulation of debt in future. Policymakers in the CECs have demonstrated varying degree of willingness to introduce mandatory private pension schemes. This may be justified by dissimilarities in the parameters of their economies. Another conclusion is that the recently implemented or planned pension reform in CECs has not solved the issue of a pension provision for good. For example, the Hungarian finance ministry estimates that thanks to the recent pension reform, the deficit of the first pillar PAYG mechanism will remain under or around 1% of GDP until 2030; however, it will then jump to around 2% of the GDP in the early 2030s. The government would have to take further reform steps before it happens, including possibly a further hike in retirement age and/or a switch to a more economical pension indexation method.

(6) Governments in other CECs may also need to revisit the issue of a pension provision in future to change parameters of their pension systems, if necessary, in response to unanticipated demographic or macroeconomic shocks. In the meanwhile, policies aimed at increasing labor participation and boosting economic growth should help raise welfare of future generations of pensioners.

(7) While some common elements seem to be consistent with the argument of a progressive convergence between different models, the comparison between European pension systems may lead to a different conclusion. Notwithstanding the existence of common challenges, present pension institutions are hugely influenced by past choicers. Institutions inherited from the past highly constrained decision-makers and contributed to define marginal or even radical reforms but still related to traditional roots. To describe such a process, the term “hybridization” is sometimes used: new systems are the effect of the interaction of different sets of institutions and goals.
5.3 Politico-economic motives

(1) In Poland and Hungary, one could observe a division of interests between the Ministry of Finance, supporting market-oriented pension reforms with a high share of capital-funded provision for old age on the one hand, and the ministries of Labor and Social Affairs with reform proposals much more oriented towards a ‘reform within the system’ on the other. These different positions have been supported by both economists (for radical market-oriented approach) and lawyers (for procedural reform). In Poland and Hungary, there have also been influential self-governing institutions for social security which have played a role in the pension reform debate and taken a political stance which is also more oriented towards gradual reforms.

(2) The conflict of interests between the Ministry of Finance and the Ministry of Social Affairs has not existed in the Czech and Slovak republics. Compared to Poland and Hungary, the Czech Republic and Slovakia, the former Czechoslovakian Republic, have presented a different picture of political actors. This might be explained by the fact that Poland and Hungary were reform countries even before 1989. However, the political change in the Czechoslovakian Republic was, in some respect, more radical, and also had a slower start of both public discussion on pension reform issues and political bargaining on social policy objectives than in Poland and Hungary. Since 1995, the situation has changed significantly, at least in the Czech Republic. In that year, a comprehensive strike, arranged by the trade unions, took place in protest against the rise in the retirement age. In the 1998 election campaign, the pensioners’ party’s main political goal was a more regular indexation mechanism for pensions; pension issues became an increasingly public issue.

(3) The situation and developments in Slovakia have been again different from those in the Czech Republic. Political actors in pension politics in Slovakia are difficult to identify; political processes are often characterized by a lack of transparency.

(4) Analyses of economic transformation stress the role of strong and aggressive trade unions in Poland. In the early years, the Solidarity movement was an influential actor fighting for the improvement of pensioners’ income by advocating indexation and valorization. Nevertheless, their role has changed, and in the late 90s they supported the partly privatizing pension reform in Poland.

(5) Generally, in all NEW-8, the role of employees/trade unions on the one hand and employers’ organizations on the other was rather limited in the beginning. However, with continuing transformation, the employees/employers have acquired an increasingly influential role in the pension reform debate.

An important reason for the feasibility of radical economic reforms has been identified as ‘the honeymoon effect’ in the transition societies: even a short honeymoon period after the break with communism allowed comprehensive economic reforms and market changes in distribution. Social reforms nevertheless did not belong to these first radical reforms. In the field of pension reform, the ability to reform is more protracted – in Poland there was a broad consensus in all parties on the necessity for reforms; the socialist government introduced reforms and this policy was continued by the following liberal government.

(6) In the Visegrad states, German and Austrian influences were the starting-point for their own social security development. The Central and Eastern European countries are often argued to have continued former traditions which were interrupted by the socialist period,
including those in the field of social security. However, the construction of multi-pillar systems does not simply take up past traditions, but it is an international, new combination of social insurance in the first pillar with a funded and mandatory second pillar (pushed strongly by the World Bank).

(7) The recent years are characterized by the strong promotion of liberalization and social security systems and a targeting of the welfare state primarily on minimum protection. One can connect this development to the ‘globalization’ discussion in politics and economics, emphasizing aspects of international competition and their impact on social policy, as well as the growing activity in the field of social security of the World Bank, which began in Latin America in the 1980s and has spread to Central and Eastern Europe since the mid-1990s. Foreign experts seem to have acted in some respect as ‘gate-keepers’ in the reform discussion – especially during the early years – and have concentrated on the demographic problems to be solved by capital-funded systems.

(8) One can identify certain paradigmatic approaches within the different international agencies (e.g., ILO and World Bank). However, the positions of these agencies have changed over time. Reforms that have been introduced, with the assistance of the World Bank, in Latvia, Hungary, and Poland do not exactly copy the approach advocated, but are in line with the World Bank’s multi-pillar approach and the division of labor between the public and the private sectors.

(9) It has been argued that the ‘radical’ reforms in Poland and in Hungary are a response to their external debt, plus a higher degree of pressure from the World Bank, whereas the lower external debt of the Czech Republic allowed them to choose their own approach to pension reform. Nonetheless, the Czech Republic had also discussed the introduction of a mandatory second pillar with increasing seriousness in the years 1997/98.

(10) Last not least, transition societies have witnessed the changes taking place in neighboring countries, which have been faced with the same problems under historically specific conditions. They have profited by their neighbors’ experience and learnt from their mistakes. This ‘transitional learning’ has been observed during several phases of welfare state development and in different countries. (The so-called ‘transnational learning’ or ‘wait and see’ model (Abbott and DeViney, 1992) describes policy adoption as taking place in only a few countries while the others stand by and observe the success or failure of the strategy.) There is no evidence that there has been direct transnational influence between the NEW-8-countries. However, the reforms and their outcome have been discussed by experts of these countries as well. When examining the circumstances that enabled pension privatization in the NEW-8, it turns out that the driving forces of pension privatization proved to be the neo-liberally minded ministries of finance and economics, backed by the international financial institutions’ policy advice and financial support. Many local pressure groups opposed structural pension reform. These groups’ room for maneuvering was shaped by economic conditions, political and institutional factors, and earlier policy choices. (For a more detailed (and different)

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10 Chlon-Dominczak and Gora (2003) found in a recent study (published in Holzmann et al., 2003), based on a survey given to experts and decision-makers, that in the CECs international institutions that provide technical and financial support for the reforms played an almost equally important role than governments did. Domestic experts and trade unions also took an important role. The role of private financial institutions was less important.

11 Various case studies have stressed the importance of political leadership and the ability to communicate a coherent neo-liberal vision. It has also been shown that a preceding crisis may induce radical change.
discussion of the political economy of pension reform in transition economies and the role of the multilateral lenders and bilateral donors see Mueller, 2003; see also Holzmann et al., 2003.)

(11) Against the background of an aging electorate (see Figures 1 and 2 in the Appendix), one can argue that the longer the NEW-8 countries wait with installing the necessary pension reforms the more difficult will it be to get them implemented. Pension reforms require the support of the majority of voters, and reforms that aim at reducing the size of unfunded pension systems are likely to be opposed by the old.

6. Conclusion

Various aspects should be taken into consideration when assessing the value of the pension system reforms in the individual NEW-8 countries.

(i) Even the best technically prepared pension reform fails if it does not reflect the preferences of a country, and is not credible to its people.

(ii) It is an old principle that children (have to) care for their parents when those get old. However, such insurance systems tend to create moral hazard problems. Some children waive or decline to getting own children (thus saving costs/burdens of raising children). Others do not work (hard enough), thus saving costs/burdens of paying contributions to the pension system. This danger is partly met by introducing notionally defined-contribution systems (NDC), i.e. through strengthening the link between contributions and benefits at the individual level. However, as we have seen, these have caveats of their own.

(iii) The public usually (particularly in the NEW-8) wants a government to fulfill/organize an insurance function (depending on the dominant view of the role of the state). Therefore there is the need for a first, publicly pre-funded pillar, or, at least, for the government to provide a minimum pension for everybody which could be financed through taxes.

(iv) There is good reason for introducing a privately pre-funded pillar (to be supplemented by voluntary private funding) when the old-age dependency ratio is high and/or is expected to rise drastically over the coming years. This is the case in (some of) the NEW-8.

Furthermore, it has been argued that the larger the implicit pension debt, the smaller the likelihood of radical pension privatization. Another argument focuses on the influence of the international financial institutions. The political economy of pension reform literature usually begins from the premise that path dependencies created by existing political institutions and policy structures constrain the development of new domestic policies. Radical change is explained through a model of shock and response in which domestic policymakers tend to enact policy change when faced with a crisis. When asking the question why do policymakers choose one or another response the answer usually involves politics, which is understood as a competition for resources among self-interested actors and interest groups.

Public choice considerations suggest that an aging electorate increases the relevance of pension spending on the agenda of office-seeking policy makers and tends to increase the size of unfunded pension systems. Calibrating the strength of these effects for the larger EU countries and the US, Galasso and Profeta (2004) found that the latter political aspect always outweighed the former.


Private funding (FF) may arise similar problems as state commitment may create similar moral hazard problems.
More important than the system question, however, may be the extent of how properly designed the chosen system is and whether (and under which costs) it can be implemented. Whether a pension system is appropriate or useful in a specific country, is therefore a question of the historical path and the nature of the debate in each single country.

(v) In addition, even if a 3-pillar pension system appears to be appropriate for an individual NEW-8 country, it will likely be not enough. It may also be important for such a country to
   a) raise the retirement age (if possible)
   b) decrease the benefits
   c) raise the contribution rates
   d) strengthen fiscal consolidation.16

(vi) The “coronation path” (the best option) in the NEW-8, however, would be to increase economic growth to a sufficient extent.

(vii) Nonetheless, good macroeconomic policy is an unavoidable precondition and a necessary insurance against the long-term challenges of population aging and the danger of fiscal non-sustainability.

(viii) Against the rising difficulties of implementing the necessary pension reforms in an aging society, the NEW-8 countries are required to hurry up with the implementation of these reforms.

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16 MacKenzie et al. (2003) argue that „(p)ension privatization, if not offset by fiscal consolidation, can loosen the fiscal stance in some circumstances“. In other words, a “simple conversion of a public pay-as-you-go system to a private defined contribution one is not a guaranteed path to higher national saving. In most cases, higher savings can only be assured by making the pension system less generous (…). Thus, the decision about whether to privatize or overhaul a public pension system may ultimately have more to do with political and philosophical considerations than with economic ones.”
References


Data Sources


European Commission (EC), 2003, “Public Finances in EMU 2003” (Brussels).

Appendix

Table 1. Pension System in the CECs

Czech Republic
2-pillar system, of which 1 pillar with compulsory membership.

<table>
<thead>
<tr>
<th>Compulsory membership:</th>
<th>for employees, self-employed persons, persons having equal status (students, nursing staff etc.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum contribution periods:</td>
<td>15 years prior to the age of 65</td>
</tr>
<tr>
<td>Standard retirement age:</td>
<td>between 53 to 57 years for women, graduated according to the number of children; 60 years for men</td>
</tr>
<tr>
<td>Amount of pension:</td>
<td>depending on income and periods of insurance</td>
</tr>
</tbody>
</table>

1st pillar: pension system with compulsory membership financed by contributions based on the idea of solidarity.  
2nd pillar: voluntary private pension insurance (which, however, is still in its initial stage).  
There are hardly any company pensions.

Hungary
3-pillar system, of which 2 pillars with compulsory membership.

<table>
<thead>
<tr>
<th>Compulsory membership:</th>
<th>for employees, cooperative members, self-employed persons, unemployed persons, soldiers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum contribution period:</td>
<td>1st pillar 15 years as a rule (20 years for full pension); 2nd pillar 180 months</td>
</tr>
<tr>
<td>Standard retirement age:</td>
<td>62 years in case of both pillars</td>
</tr>
</tbody>
</table>
| Amount of pension: | 1st pillar – average monthly income and periods of insurance: at least HUF 16,600  
2nd pillar – depends on the kind of pension fund chosen: at least 25% of the 1st pillar |

1st pillar: state pension (pension system under which pensions are financed by the contributions of the working population)  
2nd pillar: private pension (setting-up of a compulsory pension fund)  
3rd pillar: voluntary private pension (or life) insurance  
Persons who were already insured in the state social insurance prior to January 1st 1998 could choose a private pension fund at their discretion. Persons who have not chosen a pension fund will receive their pensions exclusively from the state pension insurance.

Poland
3-pillar system, of which 2 pillars with compulsory membership.

<table>
<thead>
<tr>
<th>Compulsory membership:</th>
<th>for employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum contribution periods:</td>
<td>20 years for women, 25 years for men</td>
</tr>
<tr>
<td>Standard retirement age:</td>
<td>60 years for women, 65 years for men</td>
</tr>
<tr>
<td>Amount of pension:</td>
<td>depending on the reference wage or salary and the number of years of insurance</td>
</tr>
</tbody>
</table>

1st pillar: Each person or employee maintains a separate account with the social insurance institution. The overall contribution or a portion thereof is paid to this account, depending on whether the person is entitled or obliged to participate in the 2nd pillar. All persons subject to social insurance are obliged to participate in the 1st pillar.
The 2nd pillar consists of private pension fund. Participation in the 2nd pillar is obligatory for all persons born after December 31st, 1968. Persons born between December 31st, 1948 and January 1st, 1969 may participate on a voluntary basis. Persons born up to December 31st, 1948 are only entitled to participate in the 1st pillar. Part of the pension contribution by the insured person for participating in the 2nd pillar is transferred from the accounts maintained with the social insurance institution to the private pension fund selected by the entitled persons.

Participation in the 3rd pillar is on a voluntary basis. This pillar comprises life insurance premiums paid into an investment fund by the employee or the employer.

**Slovakia**

2-pillar system, of which 1 pillar with compulsory membership.

- **Compulsory membership:** for employees, cooperative members, self-employed persons, unemployed persons, soldiers
- **Minimum contribution periods:** 25 years for full pension; in case of partial pensions: 10 years for women; 20 years for men, 20 years for military service
- **Standard retirement age:** 62 years for women and men (step-by-step adaptation from previously 57 years and 60 years, respectively)
- **Amount of pension:** depending on the duration of employment, occupational hazard, sex, amount of income during active service

1st pillar: pension system with compulsory membership financed by contributions based on the idea of solidarity.
2nd pillar: voluntary private pension insurance (which however, is still in its initial stage). There are hardly any company pensions.

**Slovenia**

3-pillar system, of which 1 pillar with compulsory insurance.

- **Compulsory membership:** for employees, self-employed persons, trainees/apprentices, civil servants, farmers, unemployed persons
- **Minimum contribution periods:** 15 years
- **Standard retirement age:** graduated by the number of years of insurance; 58 to 65 years for men, 58 to 63 years for women
- **Amount of pension:** depending on previous income, years of insurance

1st pillar: state pension (pension system with compulsory membership under which pensions are financed by the contributions of the working population)
2nd pillar: private pension (setting-up of a compulsory pension fund)
3rd pillar: voluntary private pension (of life) insurance
Contributions to the second and the third pillars are made on a voluntary basis.

Source: Bank Austria Creditanstalt, 2004
<table>
<thead>
<tr>
<th>Main reforms</th>
<th>Statutory schemes</th>
<th>Private pillars</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Czech Republic</strong></td>
<td>1993, 1995, Defined benefit PAYG financed from social security contributions</td>
<td>Voluntary, tax expenditure subsidised of moderate importance</td>
</tr>
<tr>
<td><strong>Estonia</strong></td>
<td>1997 PAYG earnings-related similar to German system</td>
<td>Voluntary, tax expenditure subsidised of minor importance</td>
</tr>
<tr>
<td><strong>Hungary</strong></td>
<td>(1994) 1998 Defined benefit PAYG financed from social security contributions</td>
<td>Voluntary (94) Mutual Benefit Funds, tax expenditure subsidised moderate importance</td>
</tr>
<tr>
<td><strong>Lithuania</strong></td>
<td>2003/2004 Classical PAYG DB w. flat-rate &amp; earnings-related part financed from gen. Taxation &amp; social security contributions</td>
<td>“Hybrid” voluntary pillar financed with public pension revenues. No fund established yet.</td>
</tr>
<tr>
<td><strong>Poland</strong></td>
<td>1998 NDC based</td>
<td>Voluntary, tax expenditure subsidised of moderate importance</td>
</tr>
<tr>
<td><strong>Slovenia</strong></td>
<td>3 pillar reform rejected 1999, existing pillar strengthened thereafter</td>
<td>Voluntary, tax expenditure subsidised of minor importance</td>
</tr>
<tr>
<td><strong>Slovakia</strong></td>
<td>Major reform planned for 2003/2004</td>
<td>Voluntary, tax expenditure subsidised of minor importance (1996)</td>
</tr>
<tr>
<td><strong>Cyprus</strong></td>
<td>1995 (introduction of social pension)</td>
<td>Voluntary, of minor importance</td>
</tr>
<tr>
<td><strong>Malta</strong></td>
<td>No major reforms recently</td>
<td>Voluntary, of minor importance</td>
</tr>
</tbody>
</table>

**Table 2. Basic Characteristics of (Reformed) Pension Systems in the new Member States**

DC = Defined Contribution. DB = Defined Benefit. PAYG = Pay as you go i.e. financing current benefits out of current revenues. NDC = Notional Defined Contribution, i.e. a system with individual contribution accounts where benefits for individuals are calculated as sum of individual contributions times a factor of real growth in the economy in the contribution period.

* Whether these elements in overall provision should be categorized as the 2nd part of 1st pillar provisions or actual 2nd pillar depends on the jargon applied. In the Swedish system the NDC and the fully funded DC element are integral parts of the first pillar.

Source: Commission of the European Communities, 2004, p. 106
### Table 3. Main measures in the PEPs concerning pension reform

<table>
<thead>
<tr>
<th>Country</th>
<th>Funded pillar – developed</th>
<th>Planned reforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>CZ</td>
<td>X</td>
<td>1&lt;sup&gt;st&lt;/sup&gt; pillar: parametric reforms within fiscal consolidation, Notional Defined Contribution reform foreseen for 2010 No plans for the compulsory funded pillar</td>
</tr>
<tr>
<td>EE</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>LV</td>
<td>✓</td>
<td>More generous indexation rule in the NDC pillar</td>
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<tr>
<td>LT</td>
<td>X</td>
<td>Introduction of a voluntarily pillar as of 2004</td>
</tr>
<tr>
<td>HU</td>
<td>✓</td>
<td>Gradual introduction of the 13&lt;sup&gt;th&lt;/sup&gt; month pension Increase contribution rate to mandatory funded pillar</td>
</tr>
<tr>
<td>PL</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>SI</td>
<td>X</td>
<td>Parametric reforms in the 1&lt;sup&gt;st&lt;/sup&gt; pillar</td>
</tr>
<tr>
<td>SK</td>
<td>✓</td>
<td>Introduction of a compulsory funded pillar planned for 2005</td>
</tr>
</tbody>
</table>

Source: EC 2003, p. 37
Table 4. Reformed pension systems in EU-25 according to main features

<table>
<thead>
<tr>
<th>Country</th>
<th>PAYG Flat-rate Public 1st pillar</th>
<th>PAYG Earnings-related, Public Single or 1st pillar</th>
<th>Pre-funded “Mandatory” or “Major” 2nd pillar</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>“Beveridge”</td>
<td>“Bismarck”</td>
<td>“NDC”</td>
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<tr>
<td>Belgium</td>
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<td>Italy</td>
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<td>“NDC”</td>
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<tr>
<td>Luxembourg</td>
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<tr>
<td>Netherlands</td>
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<td>Portugal</td>
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<tr>
<td>Sweden</td>
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<td></td>
<td>“NDC”</td>
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<tr>
<td>UK</td>
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<tr>
<td>Cyprus</td>
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<tr>
<td>Czech Republic</td>
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<td>Estonia</td>
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<td>Hungary</td>
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<td>Latvia</td>
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The above categorization is focussed on main features and thus rather crude. For a presentation of the complexities and nuances of national pension systems in EU 15 please consult “The Joint Pension Report“ 2003. For further information on pension systems in the new Member States please consult “Social Protection in the Applicant countries”, BXL, Dec. 2002. A few countries (Finland, France & Greece) fall between the categories and this is indicated with combined colours.

Source: Commission of the European Communities, 2004, p. 109
Figure 1. Average Annual Rate of 2002 Population Change, Medium Scenario (percentage)

Source: UN, 2004 (own calculations)

Figure 2. Old Age Dependency Ratio (percentage)

Source: UN, 2004 (own calculations)