Croatian pension system: past, present and future

- Problems recognized – the reform started
- Unsustainable public expenditure on pensions
- Need to continue the pension reform

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Pension reform – a never-ending story

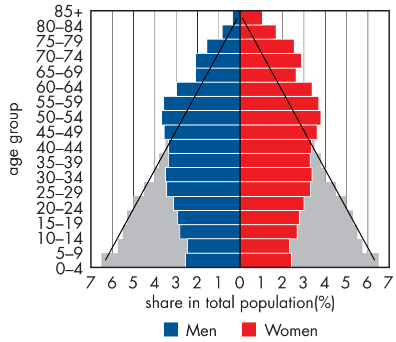
Introduction

Pension system reform is one of the priorities of both developed and transition countries. The issue has become especially prominent in the past two decades. The main objective of pension system reform is to create a socially equitable and financially stable pension system. In other words, find the perfect balance between equitable pensions and financial sustainability of the system. This is neither simple nor easy. To the contrary, it is a complex, politically sensitive and economically challenging process. This publication aims to provide a concise overview of the pension system reform in Croatia that had been launched in 1999, by providing an analytical context of the transition of Croatia's economy and, finally offer conclusions intended for all social groups concerned concurrently providing economic policy makers with well-intended recommendations.

This publication puts the spotlight on the three most important factors that determine the stability and the sustainability of a pension system: demographics, economy and regulations. In order to enable easier understanding of the (negative) changes within the pension system, a short overview of the pension system reform in Croatia is given in the first part of the publication, providing insight into the mini-reform of 1999 and the key second phase of 2002, when the system of individual capitalised savings was introduced. By transferring to the fully-funded scheme the insurance risks are shared among several levels and insurance carriers. The three pension insurance pillars should guarantee greater social security to future pensioners, i.e. higher pensions, thus minimising risks associated with old age. The positive effects of the started pension reform contributed to individual responsibility of citizens for their own future and standard of living in old age. Today, some twelve years later, we can see that stable pension fund returns have surpassed initial forecasts, while savings accumulated in the second pillar have been predominantly used to lend to the government, with an exceptionally positive impact on the development of the domestic financial market.

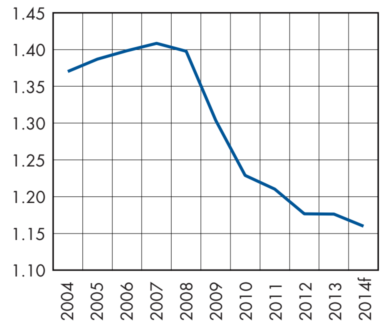
However, as we have witnessed, thus far reforms have not solved the problem of equitability and financial sustainability of the pension system. Continuous strong growth of pension expenditures is a consequence of unfavourable demographic developments, post-war transition marked by strong deindustrialisation and loss of competitiveness, and consequently loss of jobs and lack of strategically well-developed economic policy measures. Frequent election cycles have resulted in periods marked by (early) retirements because burning social issues were oftentimes resolved by avoiding painful structural reforms. In the short-term this provided an illusion of a solution being found for the pension, i.e. fiscal deficit. Consequently, the ratio between the number of persons insured and persons retired has dropped to its lowest levels since Croatia gained its independence and is among the highest in Europe (1.18). The increase in the number of retired persons (with a high percentage of those entitled to privileged or disability pensions) paired with the simultaneous reduction in the number of the employed widened the deficit of the public pension deficit as one of the main forerunners of the unsustainable growth of the current and overall fiscal deficit. Namely, only slightly over a half of total pension expenditures (some 60%) are covered by current revenues arising from pension contributions. Consequently, the state budget is continuously faced with the increases in fiscal deficit, i.e. public debt, necessary for current needs to be financed. After a long perod lacking consolidation

Age group, share in total population*



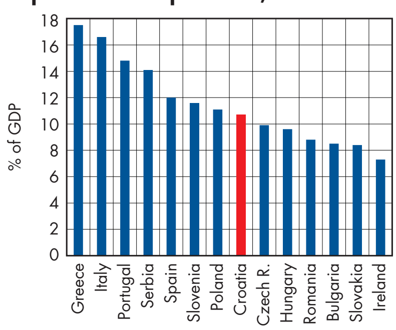
** The Census of Population 2011; lines of the triangle represent the normal distribution*
Sources: CBS, Raiffeisen RESEARCH

Contributors/pensioners ratio



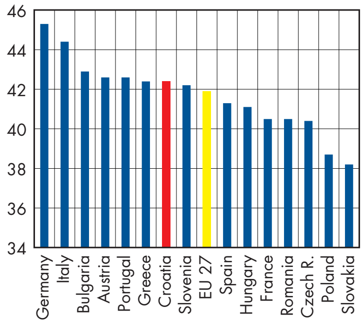
Sources: CPII , Raiffeisen RESEARCH

Expenditure on pensions, 2012.



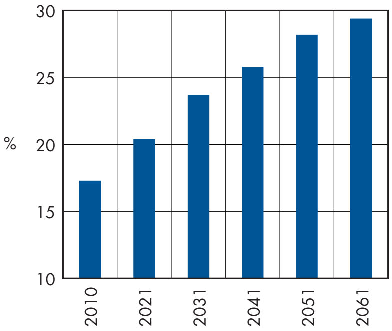
Sources: Eurostat, Raiffeisen RESEARCH

Median age of population, 2013.



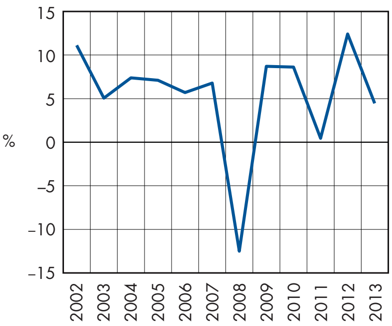
Sources: Eurostat, Raiffeisen RESEARCH

Share of population aged 65+ (in Croatia)



Sources: CBS, Raiffeisen RESEARCH

Annual yields of mandatory pension funds (MIREX B*)



** MIREX - a relative measure of performance in relation to the average result*
Sources: CFSSA, Raiffeisen RESEARCH

momentum as regards the way the fiscal policy is run and following its accession the EU, Croatia entered the Excessive Deficit Procedure (EDP), committing to cut its consolidated general government deficit to below 3% of GDP within a three-year period and slow down the unsustainable growth of its public debt, aiming to ultimately reduce it to below 60% of GDP. Since the beginning of this year the requirements under the EDP have been complied with through the adoption of a series of "consolidation" measures at the revenue side of the budget. The pension system contributions arising from accelerated pension plans have been changed as of 1 April 2014, enabling mandatory pension fund members to leave their funds and transfer their capitalised savings into the state budget. The impression of a strong fiscal effect resulting from by no means negligible amount of withdrawn assets in essence represents an implicit return to the pay-as-you-go system that was abandoned as a predominate system because it was inadequate and financially unsustainable. Instead of continued pension system reform that was supposed to push towards an increase in relative contribution payments to the second pillar of the pension insurance, we have witnessed opposite ideas being implemented.

Amid long economic and fiscal crisis, assets accumulated at private accounts of pension beneficiaries are occasionally seen as an attractive "bag of gold" to be used for coverage of sizeable current expenses. However, the ultimate result of such regressive interventions in the second pillar represents a future implicit increase in public debt, heavier tax burden and dependence of future pensioners on the number of the employed in the future and the then current economic situation in the country. Such one-off measures are especially dangerous for countries with dwindling birth rates (as is the case in Croatia) due to the expected decline in the number of active working-age population and the increasing share of the aged population. The one-off fiscal effect is thus turned into the implicit future debt at the moment when pensions of future pensioners need to be paid to them. Therefore, we believe the readers of this publication will realise that in the long run no justification for such measures can be found and that instead the question of how to increase contribution payments to the second pillar will come to the foreground. The distribution of responsibility across three pension system pillars takes into account the time horizon which is very important in designing a pension system reform from the aspect of ensuring equitability and sustainability of the system as a whole. However, the four-year election cycle provides a fertile ground for hasty decisions which may seriously jeopardise the stability of the entire economy and have far-reaching negative consequences on the standard of future generations. Finally, we give a short presentation of the results of the recently conducted survey aimed at establishing the reputation and social standing of pension funds in Croatia. Numerous advantages of voluntary pension plans have been recognised. However, we believe that this publication will help their additional affirmation, especially from the viewpoint of employers. This includes the use of tax reliefs paired with ample capitalisation of invested assets (also including state subsidies) at personal accounts of employees.

It arises from the above-mentioned that there is no alternative to (painful) structural consolidation measures across the entire spectrum of (well-known) steps in order to ensure pension equitability, while distributing the burden of pension insurance between the state budget and insured persons themselves, this being an option with the highest chance of success in the long run.

1. Pension reform in Croatia

1.1. The period prior to the introduction of the second and third pillar

The problems in Croatia's pension system became visible already in the 1980s, and as such are not specific only for Croatia. Pressured by demographic problems most developed countries also found themselves faced with a challenge of designing a sustainable pension system. Gradually, over the years, both developed and transition countries, have introduced old age individual pension plans next to the pay-as-you-go system using private pension funds in order to find solutions for the rising public expenditures used for making up for the insufficient funds in the pay-as-you-go pension insurance system. The reforms have aimed to create a sustainable pension system by diversifying the sources for financing pensions, predominantly by reducing public and increasing individual responsibility for pensions.

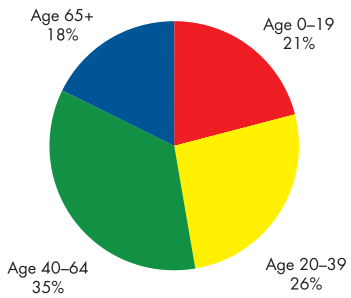
However, in most countries not only have pension system reforms not been seen through, but their success has largely remained limited by the fact that economic policy makers have neglected to support pension system reforms through reforms in various other segments. This is true especially for the labour market and education system reforms as the key elements in creating a competitive economy, enabling first-time employment and long-term empoyment. Not to mention the boost to the inflow from contribution payments largely used to finance current pensions.

As in most countries, the ratio between the number of persons insured and persons retired has deteriorated over the years in Croatia as well. While this ratio has been shrinking, under the influence of demographic and economic developments (especially in the labour market), not to mention political decisions, the share of the average pension has gone up, under the influence of regulation changes that expanded and increased the rights of pensioners. However, since these changes have not been based on rational but predominantly hasty decisions and since the pension system has, as a rule, been used to deal away with economic and social problems, the financial sustainability of the pension system became questionable even prior to Croatia gaining its independence.

The Homeland War and the process of transition additionally exacerbated the system's imbalances, so the ratio of the persons insured to pensioners dropped to 1.66 already in 1996, with the sizeable decline of the share of the average pension in the average wage. At the same time, given the rise in the number of pensioners, pension expenditures grew at an accelerated rate (both as a share of GDP and in the state budget). The situation in the public finances required certain measures, which were launched in 1999. They are known as the "mini-reform" which was aimed at making the pension system more sustainable. The measures undertaken in 1999 included rising the age of retirement, prolonging the period taken for pension calculation, changing the indexation formula, tightening the criteria for awarding disability pensions, etc.

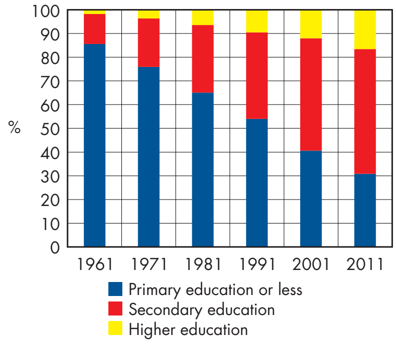
The consequences of the mini reform in the ten year period 1999 – 2008 were the rise in the legal retirement age (from 60 years of age to 65 for men and from 55 years of age to 60 for women), the rise in the minimum age for early retirement, with the years of age (instead of the length of service) becoming the key

Population by age (share in the total population)*



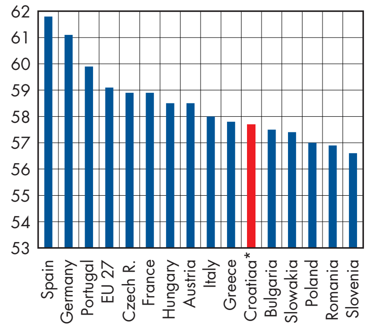
** according to the Census of Population, Households and Dwellings 2011*
Sources: CBS, Raiffeisen RESEARCH

Population aged 15+ by educational level*



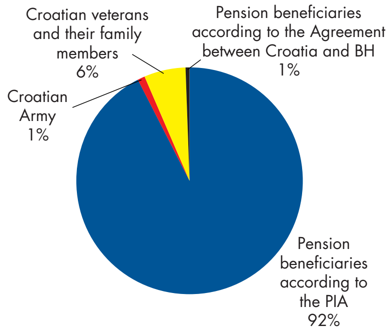
** according to the Census of Population, Households and Dwellings 2011*
Sources: CBS, Raiffeisen RESEARCH

Age at which the person first received an old-age pension, 2012.



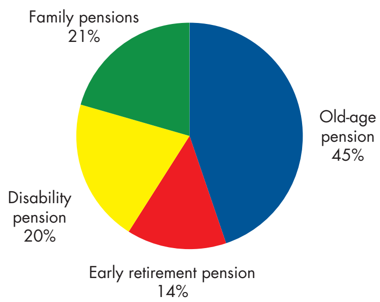
** data collected by the survey (include regular and special old-age and early pensions)*
Sources: Eurostat, Raiffeisen RESEARCH

The structure of pension beneficiaries, September 2014



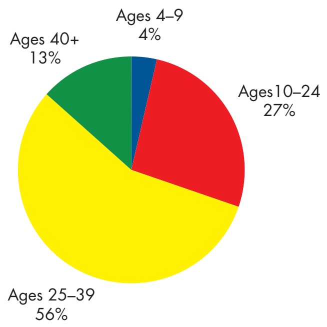
Sources: CPII , Raiffeisen RESEARCH

The structure of pension beneficiaries under the PIA, September 2014.



Sources: CPII , Raiffeisen RESEARCH

Pension beneficiaries according to years of service*



** Pension beneficiaries according to the PIA, September 2014*
Sources: CPII , Raiffeisen RESEARCH

criterion for meeting the age criteria and pension entitlement (provided that the person has completed at least 15 years of service).

New categories of pension beneficiaries (disabled Homeland War Veterans and families of killed Homeland War veterans) resulting from the difficult post-war period additionally exacerbated the problem of pension system sustainability. According to the latest data of the Croatian Pension Insurance Administration (HZMO), in September 2014 the share of disabled persons in the total number of pension beneficiaries almost neared 25%. There are substantial differences in the average amount of disability pensions paid, depending on the category of the disabled pensioner[1]. Some 7% of the total number of pension beneficiaries relates to the category of Croatian Homeland War veterans and members of their families, while only 13.4% of retired persons have put in 40+ years of service. Only 45% of persons retired realised their right by reaching full old-age retirement pension[2].

The post-war transition period was marked by unsuccessful privatisation process and a lack of strategic economic policy measures. It was also a period of generous early retirements (with the average age of retirement 50/55 years of age) and a low old-age retirement threshold (55/60). Indecision and/or lack of expertise in the creation of economic policy amid the circumstances of strong deindustrialisation paired with the untransparent privatisation process resulted in dwindling chances of finding employment, so various types of retirement were used to soften possible negative social impact.

Negative demographic developments and the mentioned economic difficulties in the period from 1990 to 1999 resulted in the increase of the number of pensioners at the annual rate of 4.5% which was paired with the dwindling numbers of active insured persons at the average rate of 3.3% per year and of the active population at the rate of 0.8% per year.

[1] The average disability pension under the Pension Insurance Act totalled HRK 1,965 in September 2014, while the average pension realised by active military personnel, police officers and authorised officials totalled HRK 3,210. Croatian Homeland War veteran and members of their families received an average disability pension of HRK 4,826 in September 2014, while the members of the Croatian Defence Council and members of their families received an average disability pension of HRK 2,779.

[2] The data relates to pension beneficiaries entitled under the Pension Insurance Act.

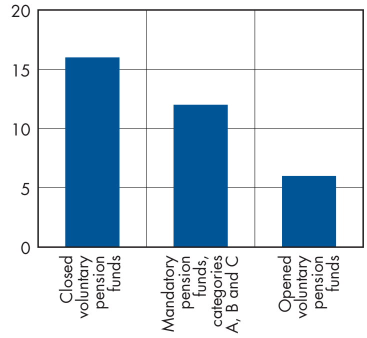
1.2. Introduction of the second and third pension pillars

The financial unsustainability of the pension system caused by demographic developments mentioned earlier and unfavourable labour market developments had been reflected in the widening of the pension deficit. Namely, current pension expenditures arising from the Pay-as-you-go system substantially exceeded current revenues from pension contributions.

A transfer to the fully-funded system was started in January 2002, dividing the insurance risks among multiple levels and insurance carriers. This is the moment considered as the launch of the key, **second phase of the pension system reform**, that is, when in addition to the first PAYG pillar (generational solidarity pillar) a fully-funded system was introduced. From that moment on, Croatia's pension system became a three-tiered pension insurance system which encompasses the first pillar, which is the intergenerational solidarity pillar, the second, mandatory pillar and the third, voluntary pillar, the two latter being based on individual capitalised savings. This means that pension savings are kept at individual accounts thus strengthening the link between the contributions paid in and pensions received, boosting the responsibility of the individual (insured person) for their own pension. The introduction of the second pension insurance pillar meant there would be a certain **transition cost** and it was not a negligible. It is estimated at some HRK 5bn (1.5% of GDP) on annual level. Since a share of pension contributions is paid into the second pillar it came to a certain shortage in the first pillar. It had been decided that the shortage will be covered from the state budget. The pension insurance contribution rate is determined by law[3] as follows: for beneficiaries of the first pillar (pension insurance based on generational solidarity) the contribution rate is 20.00%, while for persons insured under the second pillar the rate is divided into the contribution rate for the mandatory pension insurance based on the individual capitalised savings of 5% and the portion for the mandatory pension insurance based on generational solidarity, totalling 15%, of a persons salary and other bases for calculating contribution payments. The third pillar is voluntary, meaning that members choose the amount of contributions themselves.

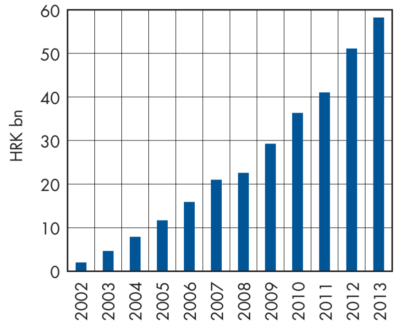
Three pension insurance pillars should guarantee grater social security of future pensioners, that is, higher pensions and thus reduce risks arising with old age. Initially, pension reform was to be continued by reducing payments to the first pillar and increasing payments to the second pillar in relative terms. The investments of pension funds enhance domestic savings and investments, widen the capital market, increase economic growth and the standard of living of future pensioners. In 2002, when the reform was first launched, optimistic forecasts estimated prospective returns of mandatory funds at some 2% above the inflation rate. Today, twelve years later, we have witnessed that Croatia's mandatory pension funds have yielded far more impressive results, irrespective of the fact that in the past period both the global and Croatian capital market were hit by a major economic crisis. According to the latest data of the Croatian Financial Services Supervisory Agency (HANFA), net assets of mandatory pension funds totalled HRK 58.2bn at the end of last year, reaching HRK 62.9bn at the end of August

Number of pension funds in Croatia, October 2014



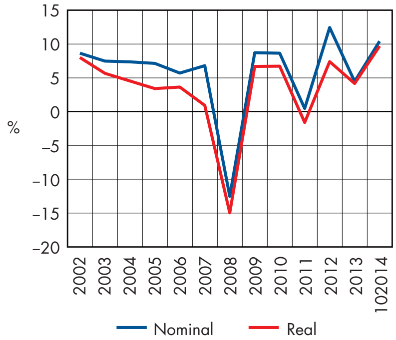
Sources: CFSSA, Raiffeisen RESEARCH

Net assets of mandatory pension funds



Sources: CFSSA, Raiffeisen RESEARCH

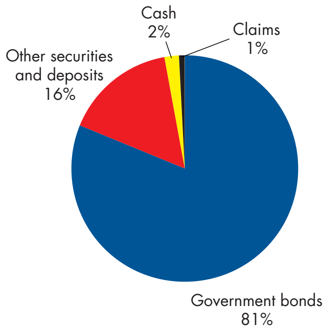
The yields of mandatory pension funds (MIREX)



Sources: CFSSA, CBS Raiffeisen RESEARCH

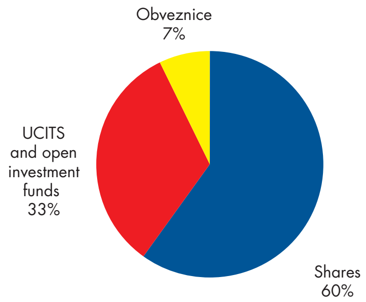
[3] The Law on Social Securuty Contributions OG no. 84/08, 152/08, 94/09, 18/11, 22/12,144/12, 148/13,41/14.

Domestic assets of mandatory pension funds, July 2014



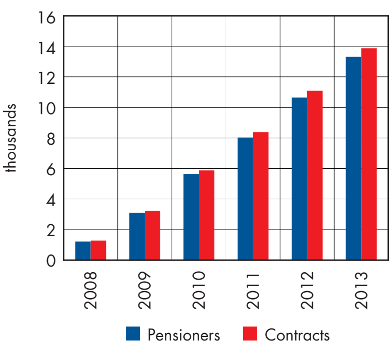
Sources: CFSSA, Raiffeisen RESEARCH

Foreign assets of mandatory pension funds, July 2014



Sources: CFSSA, Raiffeisen RESEARCH

Number of pensioners and number of contracts of voluntary pension insurance



Sources: CFSSA, Raiffeisen RESEARCH

2014. In addition, annualised average returns of domestic mandatory pension funds have totalled 5% ever since the time of their inception, which reflects that they have fulfilled the key objectives of the pension reform launched in 2002. They ensure the security of assets received from their members on one side, while on the other they provide a high return which guarantees greater pension savings, in line with the the criterion of equitability.

However, some interventions into the system in the period up to 2008 put in question the initial financial objectives of the 2002 pension system reform. The factors for determining early retirement decrements had been changed several times, as were the rules for defining minimum pensions. Still, after the introduction of the second and the third pillar, the largest cost-expanding interventions, substantially increasing pension costs were linked to the repayment of the pension debt[4] and attempts to solve the problem of "new pensions". Namely, persons entitled to the first combined pensions (paid out from the first and the second pillar) where those who as at 1 January 2002, the day when the mandatory individual capital savings were introduced, were between 40 and 50 years old and opted to participate in the two-pillar system. However, as it turned out, their combined pensions were substantially lower than the pensions realised only under the first pillar. This was due entirely to the short period of saving (some 10 years). At the same time, pensions of those who remained members first pillar-only members increased between 4% and 27%, depending on the year of retirement (pursuant to the Law on Pension Supplement)[5], while those supplements were not available to those who opted for membership in the second pillar. For this reason, instead of starting with the payment of first combined pensions in 2012, the government provided retirement applicants with the opportunity to realise pensions as if they were members of the first, generational solidarity pillar (PAYG). This, postponed (by 10 years) the phase of paying out combined pensions based on capital financing.

The latest regulatory changes relating to the raising of the retirement age and introduction of incentives to postpone retirement, that is, penalising early retirement have for the most part been neutralised by the renewed mention of transferring capitalised savings from the second-pillar individual accounts of insured persons into to generational solidarity pillar. Since, in our opinion, no rationale can be found for touching individual account savings we dedicated a separate chapter to this issue, titled "Threats to pension system sustainability".

[4] The Act on the implementation of the 2004 Constitutional Court decision was aimed at repaying the debt accumulated in the period from 1993 to 1998 which was then estimated a HRK 10bn. It arose from the failure of the government to regulate the decision to abandon indexing pensions to salaries by a law rather than by a regulation.

[5] It was planned at the very beginning that pension beneficiaries who realised their pensions prior to 1998 would receive a pension supplement of HRK 100 and 6% of the pension paid out in June 1998, which was planned to remain in force until 2002. However, as of 2004 this supplement has been included in the pension base.

2. Affecting factors on the pension system

2.1. Demographic trends – negative in the long run

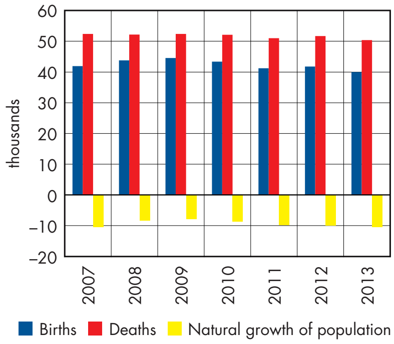
Since the 1990s Croatia's demographic landscape has been marked by continuing depopulation having to do with the aging of Croatia's population and negative natural increase[6], which is constantly in negative value, indicating considerable generational imbalance. In 2013, natural increase reached –10,447, the highest level in the past six years. Although Croatia's death rate went down in 2013, its birth rate went down as well (for the first time since 2003 it fell below 40,000), leaving the natural increase in negative territory.

The positive impact of the immigration wave to Croatia, primarily from Bosnia and Herzegovina, was offset by the share of the population that had been killed in the Homeland War on one side and increased emigration on the other. In the period from 2000 to 2008 Croatia's migration balance[7] was positive, while in the period from 2009 and 2013 it was negative, especially in 2013, when the number of emigrants hit its all-time high. This means that last year the total number of emigrants from Croatia exceeded 15 000 people, 2,385 more than in 2012. Due to Croatia's EU accession and long period of recession the trends relating to the migration balance are expected to deteriorate, resulting from the so-called "brain drain" phenomenon, which will increase the outflow of predominantly younger and better educated, working-age population.

The phenomenon of accelerated population aging has also been visible in Croatia. The share of the aged population has increased, resulting in the accelerated aging of the overall population. Thus, for example, according to the latest 2001 population census, the share of young persons of up to 14 years of age accounts for only 15% of Croatia's total population. According to the UN definition, if this share is below 20% we can speak of an old nation in demographic terms. For the first time in history, the number of persons over 60 has exceeded the number of inhabitants in the group of people aged 0 – 19, by 15%. Further, according to the age coefficient[8] Croatia's population has continued aging, underlining the negative movement of this indicator, which went up from 10.3 in 1953 to 24.1 in 2011. The increase in the share of older population is also a consequence of a long period of low fertility rate and the increase in life expectancy. Population aging brings along a decrease in the number and the share of the active population. The inflow of young generations into the labour force has been growing thin and has been paired with the growing outflow of older generations from the economically active population.

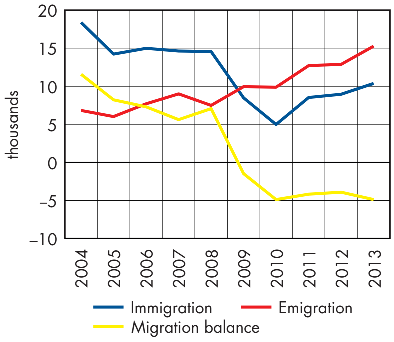
The UN demographic projections indicate that life expectancy will increase by more than 5 years over the next 50 years and that the share of old population will substantially grow in the period up to 2061. Such unfavourable demographic developments should be considered as key determinants in the design of the pension reform in the upcoming period.

Natural change in population in Croatia



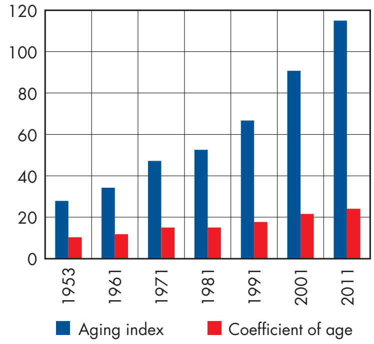
Sources: CBS, Raiffeisen RESEARCH

External migration of population in Croatia



Sources: CBS, Raiffeisen RESEARCH

The aging index and coefficient of age

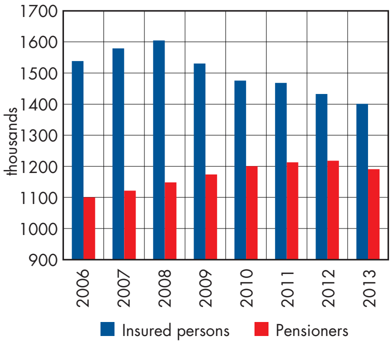


** according to the Census of Population, Households and Dwellings 2011*
Sources: CBS, Raiffeisen RESEARCH

6 Natural increase is the difference between the total number of the deceased and the total number of births in a population.
7 Migration balance is defined as a difference between the total number of immigrants to and the total number of emigrants from a specific area (in this case the territory of the Republic of Croatia).
8 The age coefficient indicates the ratio between the number of individuals aged 60 and over and the total population.

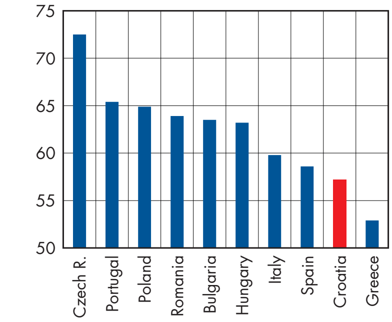
2.2. Economic developments – labour market limitations

Number of insured persons and pensioners



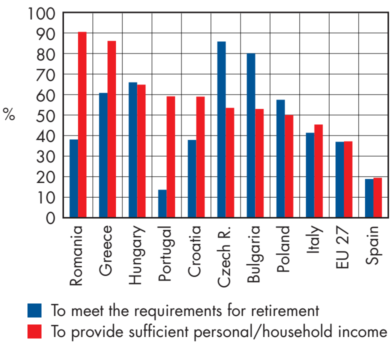
Sources: CBS, Raiffeisen RESEARCH

Employment rate in 2013 (age group 20-64)



Sources: Eurostat, Raiffeisen RESEARCH

Main reason for persons who receive a pension to continue working in 2012 (age group 50 – 69)



Sources: Eurostat, Raiffeisen RESEARCH

The above-mentioned demographic changes are not characteristic only for Croatia. They are also present in other European countries and have resulted in a substantial change in the age structure of the population, causing population aging. Amid current conditions this means the shrinking of the working-age population and the increase in the dependency coefficient, i.e. the ratio of the active to retired population. It is expected that in the EU this ratio, from the current four working-age individuals to one person aged 65 or older, should reach 2:1[9] in 2060. In addition to negative demographic trends, the second important cause of pension system unsustainability comes from unfavourable economic developments. Among the key factors contributing to pension system (un)sustainability are certainly long-term trends in the labour market: postponed initial employment due to longer education, atypical kinds of employment (occasional employment, part-time employment), the need for constant labour cost cuts and, last but not least, shadow economy. The consequence of these changes is the reduction in the potential GDP growth rate, a slowdown in the economic growth rate, strong pressure on the pension system and public finances, decrease in savings and changes in the spending and investment structures. Namely, the aptitude for saving by older generations is lower and the structure of spending considerably different because they channel their available income predominantly towards housing, social and health care services. Finally, a lower number of active working-age individuals means weaker inflow of funds needed to cover current pensions, which puts in question the sustainability of fiscal systems and/or the equitability of pensions for the third generation of citizens. All of the above leads to the conclusion that longer years of service will become necessary in all European countries, as the only way to increase the proportion of the labour force, alleviate pressure on the pension system and public finances and increase the income of pensioners.

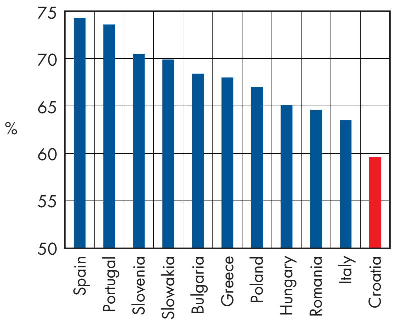
Eligibility requirements for old-age pensions are more or less the same in the majority of European countries, ranging between 60 and 65 years of age for women and 62 and 65 years of age for men. However, the majority of countries has implemented or intends to implement reforms aimed at raising the retirement age, equalising the retirement age for men and women and penalising early retirement, providing incentives for late retirement. According to the OECD data, Germany and Denmark have decided to gradually raise the eligibility requirement for full old-age pensions in the medium term, from 65 to 67 years of age, while, for instance, on Iceland the retirement age for full old-age pension eligibility already is 67 years of age (for both men and women). In contrast to the legal retirement age that makes individuals entitled to full old-age pensions, the actual age at which men and women leave the labour force differs substantially across countries. However, common to all countries is that both men and women leave the labour force earlier, i.e. opt for early retirement. At the same time, the average time spent in retirement substantially increased over the last ten years, also varying substantially among different countries. According to the CPII data for September 2014, the average age of new old-age pension beneficiaries was 63 years of age[10], while the average age of new disability pension beneficiaries was 54.

[9] Eurostat, EC: Active ageing and solidarity between generations 2012; A statistical portrait of the European Union 2012

With the proposed rise in the retirement age for women to 65 years of age, Croatia would not diverge from the EU average. As for leaving the labour force, that is, early retirement, according to Eurostat statistics both men and women in Croatia cease to be active substantially earlier than the average in the EU. However, raising the retirement age in itself will not solve the problem of the pension system and sustainability of public finances, neither will it, given the depth of the problem, make it less difficult. Pension system reform should be accompanied by the labour market reform and reforms of the health care and education systems. Namely, Croatia's activity rate of 59.6% is among the lowest in Europe and well below the EU average of 72%.

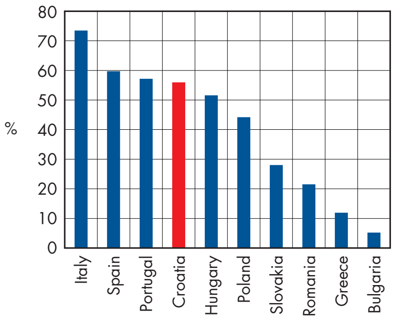
In addition to the previously described changes, it is characteristic for Croatia that early retirement[11] has been used to tackle the issue of excess employees. This means that the pension system was employed in order to use populist measures to seemingly solve social and economic problems, which in the end resulted in an almost one to one ratio of persons retired to persons employed.[12] Further, insufficient penalisation (early retirement decrement) consequently contributed to a very small difference in the amount of early retirement pension and full old-age pension, which motivated individuals to opt for early retirement, constantly increasing the number of beneficiaries of early retirement pensions. The system dependency rate, i.e. the ratio of the number of persons insured to the number of pensioners fell to its lows level since Croatia gained its independence and is among the lowest in Europe (below 1.2). Over the years a new problem has been created, that of relatively young pensioners who will remain pension beneficiaries for a long time. The necessary reform should, among other things, be directed at increasing labour market flexibility, achieving greater work force mobility, increasing the activity rate and creating incentives for late retirement paired with promoting investments into human resources. In addition to the tightening of the eligibility criteria for privileged and disability pensions, efforts should be made to find a way to reintegrate at least some of young pensioners and at least temporarily into the labour force. Although the law currently provides for (re)activation of pensioners, which can work half time and remain entitled to their pension, fact is that systematic structural problems in the Croatian labour market do not provide reasons for optimism as far as finding them jobs is concerned. It should be, amongh other things, taken into account that the probability for reemployment of persons who have been unemployed for over a year is reduced[13]. The labour market in Croatia is characterised by low employment rate and exceptionally high unemployment rate, especially among the young cohort (almost 50%), as well as the accelerated population aging which poses a serious risk in the medium and long term. Long period of recession has had a drastic impact on the Croatian labour market which, at this time, accounts for increased risk as far as developments in the country's pension system in the medium term are concerned.

Activity rate in 2013 (age group 20 – 64)



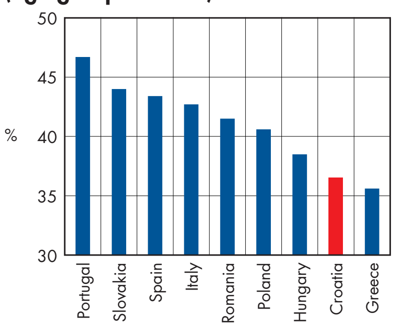
Sources: Eurostat, Raiffeisen RESEARCH

Early retirement among persons who receive an old-age pension in 2012 (age group 50 – 69)



Sources: Eurostat, Raiffeisen RESEARCH

Employment rate of older workers (age group 55 – 64)



** according to the ILO methodology*
Sources: Eurostat, Raiffeisen RESEARCH

10 The data does not include beneficiaries of pensions for active military personnel, for the beneficiaries under the Act on Croatian Homeland War Veterans and for members of the Croatian Defense Council.
11 The latest data, September 2014, indicate that beneficiaries of early retirement pensions account for 14% of the total number of pension beneficiaries who acquired their pension entitlement pursuant to the Pension Insurance Act.
12 In September 2014, the number of early retirement pensioners exceeded 160 000.
13 According to the latest data of the Croatian Employment Service (HZZ), more then a half of the total number of the unemployed has been seeking employment for longer than one year.

2.3. Regulatory framework

Croatia's pension system is regulated by some 15 different regulations. The rights arising from pension insurance are enjoyed by persons insured under the Pension Insurance Act[14] who are, subject to certain conditions, eligible for:

- pension (old-age pension, early retirement pension, disability pension, temporary disability pension, family pension, minimum pension and basic pension),
- cash compensation for physical impairment,
- occupational rehabilitation and
- pension supplement.

Amendments to the regulatory framework that entered into force on 1 January 2014 improved the penalty system for early retirement and incentives system for late retirement. The maximum early pension decrement[15] is 20.4%, while the maximum late retirement bonus is 9%. The equalisation of the age of retirement for men and women is under way, aiming to keep them in the labour force as long as possible and postpone their pension entitlement. The new Pension Insurance Act envisages the age of retirement for women to gradually rise by 2030 to 65 years of age, while after 2030 the retirement age will gradually rise to 67 years of age until 2038. In the period from 1 January 2014 to 31 December 2030 women can qualify for early old-age pension under more favourable conditions. There are certain groups of insured persons who acquire pension insurance rights under special regulations, which lay down less restrictive conditions for acquiring rights and/or more favourable conditions for determining pensions than pursuant to the general conditions that are laid down by the Pension Insurance Act. **Pensions according to special regulations** are realised by the following beneficiaries:

- active military personnel,
- police officers and judiciary officers,
- employed pyro-technicians,
- Croatian Homeland War Veterans,
- members of the Croatian Parliament, members of the Government, Constitutional Court judges and president of the Republic of Croatia,
- former political prisoners,
- full members of the CASA,
- employees of the federal authorities of the former SFRY,
- workers exposed to asbestos and some other groups,
- persons who have realised more favourable rights under former pension insurance regulations (National Liberation War participants, Croatian homeland military 1941–1945 and members of the former YNA) and
- members of the Croatian Defence Council.

In January 2014, a decision was adopted to reduce privileged pensions, exceeding HRK 5000, by 10%. Additional savings are planned with the application of the new way of adjusting privileged pensions. Namely, privileged pensions or

Transition period for old-age pension (women)

OLD-AGE PENSION (at least 15 years of service)		
Year	Years of age	Month
2014	61	0
2015	61	3
2016	61	6
2017	61	9
2018	62	0
2019	62	3
2020	62	6
2021	62	9
2022	63	0
2023	63	3
2024	63	6
2025	63	9
2026	64	0
2027	64	3
2028	64	6
2029	64	9

Source: CPII

Transition period for early-retirement pension (women)

EARLY RETIREMENT PENSION				
Year	Years of age	Month	Years of service	Month
2014	56	0	31	0
2015	56	3	31	3
2016	56	6	31	6
2017	56	9	31	9
2018	57	0	32	0
2019	57	3	32	3
2020	57	6	32	6
2021	57	9	32	9
2022	58	0	33	0
2023	58	3	33	3
2024	58	6	33	6
2025	58	9	33	9
2026	59	0	34	0
2027	59	3	34	3
2028	59	6	34	6
2029	59	9	34	9
2030	60		35	

Source: CPII

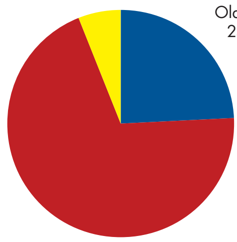
[14] Official Gazette 157/13.
[15] For beneficiaries of early retirement pensions with 40 or more years of service, the prescribed decrements are lower.

the share of pensions realised according to special regulations is adjusted on 1 January and 1 July every calendar year in accordance with the actual pension value[16], if the real GDP growth according to the data of the State Bureau of Statistic has risen by at least 2.0% each year over the three previous successive quarters relative to the same quarter of the previous calendar year and if the budget deficit over the same period was less than 3%.

It is worth mentioning that the accelerated retirement plan in Croatia is currently regulated by the Act on Insurance with Increased Duration[17] and a series of special regulations[18] and that the preparation of a new act, which is to enter into force next year, is under way. Given that as much as 84 professions in Croatia are entitled the accelerated retirement plan (close to 82 000 employees), the legislator intends to review the several decades old and outdated law and assess of the justification of the accelerated retirement plan. A compulsory medical checkup every three years has been introduced for beneficiaries of disability pensions with possible occasional control checkups. In addition, the wording of the decision on disability pension has been altered in such a way that it now lays down the jobs a worker can perform, aiming to retrain workers for appropriate jobs in order to keep them in the labour force as long as possible. Aiming to re-activate pensioners, the act currently in force provides for the possibility for pensioners to find half-time employment (for certain groups of retired persons) and keep their pensions at the same time.

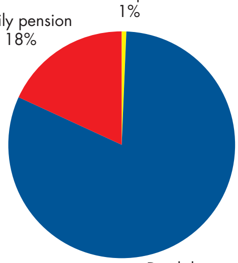
It is noteworthy that within the framework of monitoring tax evasion in the segment of employee contribution payments, the government made it impossible for employers to pay out wages without previously paying employee contributions[19]. On the other hand, due to considerable pressure on the size of fiscal deficit the government reached for amendments in the pension contribution system under the accelerated retirement plan. Namely, as of 1 April 2014 persons whose rights are regulated according to special regulations are provided with the opportunity to opt for transferring the assets from their individual, second pillar, accounts to the first pillar, since pensions for these categories of insured persons are calculated and paid out as though they were not included in the second pillar. Although the effect of this measure is significant, in fiscal terms, we find such one-off measures ill-conceived and leading to even greater problems in the medium term from the viewpoing of pension equitability. The intention of special portfolios in mandatory pension funds was to achieve higher returns for younger pension fund members. Given the current legislative solution relating to pension supplements (awarded PAYG-only participants), future pensioners qualifying for pension from both pension pillars will be faced with the problem of pension inequitability.

Pension beneficiaries under the Law of the Rights of MP, PO and AO, September 2014



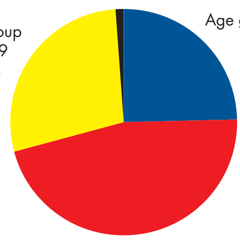
Sources: CPII , Raiffeisen RESEARCH

Pension beneficiaries under the Law on the Rights of Croatian Homeland War Veterans, September 2014*



** including CDC members*
Sources: CPII , Raiffeisen RESEARCH

Pension beneficiaries by years of service under the LRCHWV, September 2014

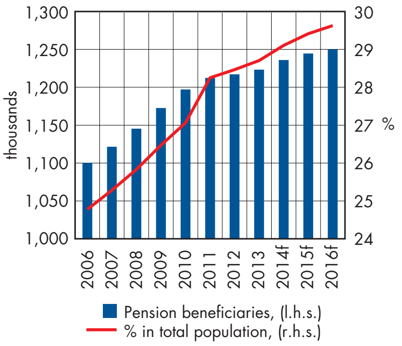


Sources: CPII , Raiffeisen RESEARCH

16 Pursuant to Article 89 of the Pension Insurance Act.
17 Official Gazette 71/99, 46/07 and 41/08.
18 Act on Rights Arising from the Pension Insurance of Military Personnel, Police Officers and Authorised Officials (Official Gazette 128/99, 129/00, 16/01, 22/02, 41/08 and 118/12); Fire-Fighting Act (Official Gazette 106/99, 117/01, 96/03, 139/04-consolidated text, 174/04, 38/09 and 80/10); Humanitarian Demining Act (Official Gazette 153/05, 63/07 and 152/08); Demining Act (Official Gazette 19/96, 86/98 and 64/00); Act on the Office for the Suppression of Corruption and Organised Crime (Official Gazette 76/09, 116/10,57/11,136/12, 148/13); Customs Administration Act (Official Gazette 68/13); Maritime Code (Official Gazette 181/04, 76/07, 146/08, 61/11, 56/13).
19 Ordinance on Amendments to the Ordinance on the Method of Payment of Contributions from Salary, Salary Receipts and Monthly Basis for Calculating Contributions Arising From Employment, Official Gazette 49/12 and 31/14.

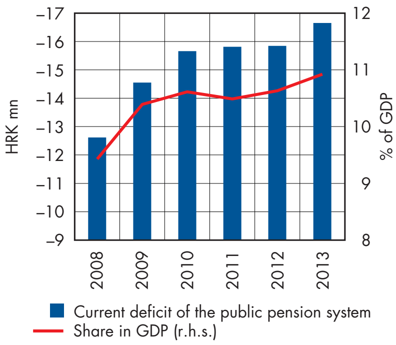
3. Threats to pension system sustainability

Pension beneficiaries and their share in total population



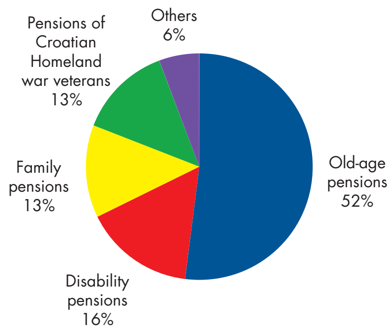
Sources: CPII , Raiffeisen RESEARCH

Current deficit of the public pension system



Sources: MF, Raiffeisen RESEARCH

Expenditure on pensions planned in 2014*



** by insurance basis*
Sources: MF, Raiffeisen RESEARCH

In the period since Croatia gained its independence not many reforms (at least by broader professional public) have been assessed as professionally designed, well-implemented and concieved as a decisive measure with expected positive impacts in the long run. Nevertheless, this was the case with the 2002 pension system reform relating to the introduction of the second and third pension insurance pillars. The other side of the medal was the **transition cost** – the amount by which contribution payments to the budget were reduced relating to the share of payments which would go to mandatory pension funds after the reform. Namely, for persons insured under the second pillar, the pension contribution rate was divided into the contribution rate for pension insurance under the PAYGO pillar, totalling 15% of wages and other bases for contribution payments, and the rate of 5% for mandatory pension insurance based on individual capitalised savings. This reduced budget revenues from contribution payments from 20% of the payment basis to 15% of the payment basis, i.e. by one fourth.

The occurrence of the so-called transition cost after the start of the pension reform is consequently linked to the rise in the current deficit of the state budget. However, implicit (long-term) debt of the pension system following the implementation of the second pillar has reduced because payment of future pensions relies less on future state budgets and more on private pension funds that have in the meantime capitalised individual payments of pension contributions. This means that it would be wrong to view the size and impact of the transition cost statically in time. The launching of the pension system reform should not be viewed only in the context of incurred costs but also in the context of future benefits. In other words, the transfer of responsibility for future pensions which will partly be financed from payments into the second pillar also represents the potentially lower future deficits of the public pension system.

Just for illustration, let us return to 2003 after the introduction of the second and the third pillar. At the time, the total number of pensioners was 1 054 549, the number of insured persons was 1 443 995, and pension expenditures totalled 9.9% of GDP. Eleven years later, according to the latest CPII data, as at the end of September 2014 the number of pensioners is 1 220 681, the number of insured persons is 1 443 744[20], while pension expenditures pursuant to the last 2014 state budget revision are at some HRK 37bn[21]. Last year, total pension expenditures stood at 10.9% of GDP.

It is noteworthy here that in the period since the second and third pillar introduction it has come to a series of interventions in the pension system, some of which have almost been regressive in character but have had a real negative effect on its financial sustainability, not to mention have contributed to greater inequality among pension beneficiaries.

For instance, pension supplements mentioned in Chapter 1 arose from one-off hasty political decisions (and practically irreversibly) generated additional costs

[20] The ratio of persons insured to pensioners went down from 1.37 in 2003 to 1.18 as at the end of September 2014.

[21] The item of pension expenses in the 2014 budget revision went up by almost HRK 340. At the same time, optimistically planed revenues from pension insurance contributions fell short so the new revised plan for budget income from pension insurance contributions was cut by almost HRK 45m (primarily as a consequence of negative labour market developments).

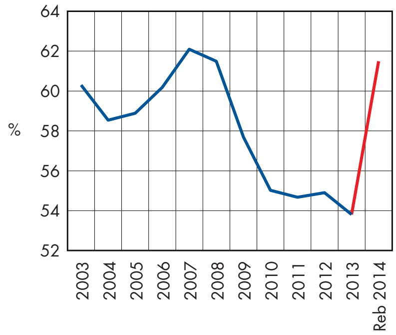
for the state budget, as well as caused greater inequality among current and future pensioners who will receive combined pensions.

Population aging, the post-transition era after the Homeland War and, last but not least, six years of deep recession, characterised by the lack of any key economic adjustment, caused strong disturbances in the labour market and additionally burdened the Croatian public pension system. Year after year, the number of pensioners has grown along with the increase in the number of beneficiaries of privileged, disability and survivors pensions paired with the simultaneous reduction in the number of the employed. This has widened the public pension system deficit as one of the most significant generators of unsustainable growth of the current and overall fiscal deficit. Only slightly over a half of total pension expenditures (some 60%) is covered by revenues collected[22] on the basis of current contributions paid into the state budget pursuant to the PAYGO principle by the currently employed portion of the population. In this context, transition cost is but one of the constituents which had a strong financial impact, increasing the current budget deficit, at the beginning of the pension system reform. Far more serious causes of the widening of fiscal deficit are the three mentioned factors: population aging, economic difficulties and exceptionally long period of recession. Hasty and ill-conceived interventions in the pension system have had and will have long-term (negative) consequences for the developments in the balance of the public pension system.

In the past two decades Croatia has far too easily missed a series of opportunities to tackle its structural weaknesses and has far too often during election cycles used the pension system to preserve social stability, further deepening fiscal imbalance in return. The accelerated growth of pension expenditures paired with the relative decline in income from pension contributions (primarily in consequence of the fall in the employment rate) resulted in the weakening of the public fiscal capacity for payment of current pensions. The unsustainabiltiy of overall public expenditures which cause uninterrupted increase in public debt used for financing current (unproductive expenses) has yet another context since the beginning of 2014. Namely, after failing to generate a decisive momentum in the domestic fiscal policy, Croatia, now an EU member state, entered into the EDP[23], committing to reduce consolidated general government deficit to below 3% of GDP within a three-year window and slow down public debt growth, finally reigning it in at below 60% of GDP.

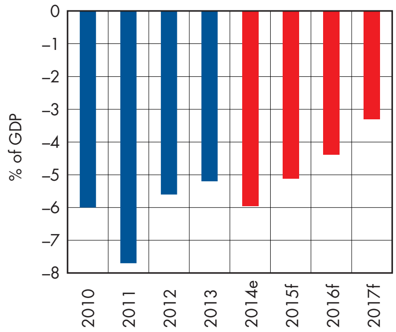
Regardless of the Government's proposed strategy as part of the so-called National Reform Programme and Croatia's Convergence Programme 2014 – 2017, where the fiscal policy framework in the medium term is determined entirely by the EDP, we have witnessed that the latest developments in the budget execution more than diverge from the planned fiscal measures. The worrying state of the state treasury is also reflected in the fact that in November 2014 the Government adopted its second budget revision, clearly indicating breaches of responsible fiscal behaviour which shows uncontrolled execution of budget expenditures and a parallel shortfall in the collection of tax revenues (but also revenues from

The ratio of revenues from contributions and expenditures on pensions*



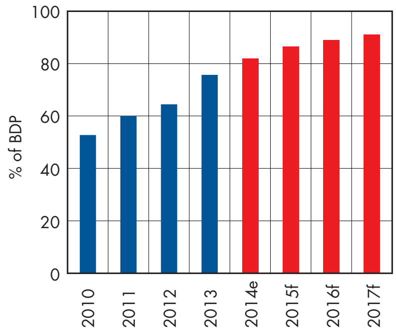
** transferred funds from the II pension pillar are included in revenues from contributions in 2014*
Sources: MF, Raiffeisen RESEARCH

Consolidated General Government deficit (ESA2010)



Sources: CBS, Raiffeisen RESEARCH

General Government Debt as % of GDP (ESA2010)



Sources: CBS, Raiffeisen RESEARCH

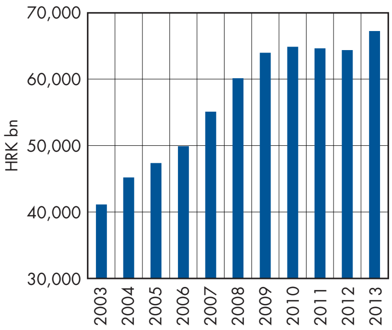
22 Over the past fiscal year a total of HRK 19.4bn was collected via pension contribution payments, while pensions paid out totalled HRK 36.1bn. Thus, pension deficit rose from HRK 15.8bn in 2013 to HRK 16.7bn in 2014.
23 EDP – Excessive Deficit Procedure

Proposed changes to taxes and contributions

Income tax*
The increase in personal deduction from 2,200 to HRK 2,600
Tax of 40% paid to the net wage higher than HRK 13,200
Minimum gross wage – nontaxable
The new changes will not apply to officials and employees in the public sector if they have a salary higher than HRK 8,800
The tax on interests on savings*
The introduction of a new form of taxation on interest earned on savings in the amount of 12%
Changes in the system of the pension insurance contributions*
Further fund transfers from the II to the I pension pillar are expected (from the accounts of the insured persons with the beneficial years of work) – is estimated at around HRK 2.2 bn
Real estate tax (2016.)
Introduction of the real estate tax by values, with the abolition of the existing municipal dues at the local level

** beginning of implementation in 2015*
Sources: www.vlada.hr; Raiffeisen RESEARCH

Social benefits to citizens and households*



** central government coverage*
Sources: MF, Raiffeisen RESEARCH

contributions). Specifically, within the framework of its last budget revision the Government increased its planned pension expenditures by as much as HRK 340m, while at the same time total revenues from contributions shrank. Forced to propose a package of measures aimed at reducing the general government deficit to 3% of GDP within a period of three years, the government answered requirements under the EDP by introducing a series of "consolidation" measures that have been executed at the revenue side of the budget. As of 1 April 2014 there are amendments to the pension system contribution scheme arising from accelerated retirement plan, enabling members of mandatory pension funds to leave their funds and transfer their capitalised assets to the state budget. The one-off fiscal effect of this measure is truly not negligible: in 2014 alone, the estimated inflow to the state budget resulting from this measure will be HRK 2.8bn, with additional HRK 2.2bn expected in 2015. Following this transfer, the insured persons in question will benefit from additional income of HRK 400m on annual level. In the circumstances when faster fiscal consolidation is required from Croatia, from the political point of view this measure seems as exceptionally simple, painless and generating substantial fiscal impact. The country did not have to go and borrow the funds drawn from the second pillar to pay out current pensions. The same will be true next year. However, what will this mean for the pension system in the year after that? The political actors are usually not concerned by the time aspect of the pension reform problem. Moreover, spurred by similar solutions in our neighbouring countries (see the table below) pension system decision-makers in Croatia are evidently prone to imitate "quick fixes" that guarantee only partial solution of the problem of pension deficit and that also only in the short term. Recurrence of negative changes in the pension system is embodied in

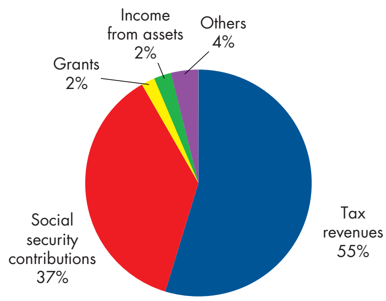
Hungary	Poland
■ abolished mandatory contributions to the second pillar, ■ In 2010 the Hungarian government decided to abolish mandatory contributions to the second pillar and these funds transferred to the first pillar, ■ the second pillar became voluntary, and the law regulates that if 70% of the members do not contribute, are diverted to the first pillar (in all four funds currently contributes only about 30% of the members given that the amounts and frequency are on a voluntary basis), ■ 2.9m of the 3m pension fund members opted for returning to the first pillar (accumulated funds on individual accounts of members who have chosen to return to the first pillar capitalized over the period of 1998–2010 years were transferred to the first pillar), ■ consequence: jeopardised confidence of its citizens in the pension system; individual foreign pension funds have withdrawn from the market; reduced rating of Hungarian public finances.	■ the contributions to second pillar funds have been reduced from 7.3% to 2.3% and the difference has been redirected to the first pillar. After a year the contribution rate to the second pillar has been increased from 2.3% to 2.8% and than in 2014 to 2.92% (the overall pension contribution rate remained unchanged, totalling 19.52%), ■ a provision regarding the public debt limit (of up to 60% of GDP) has been included into the polish constitution, ■ the second pension pillar stayed as mandarory but may not invest in government bonds, ■ 10 years before the legal age for retirement, assets are transferred to the first pillar, which will be the payer of pension from the second pillar.
Latvia, Estonia and Lithuania	
■ similarly as Poland, Latvia reduced its contribution rate to the second pillar from 8% to 2%, while Lithuania reduced it from 5.5% to 3% and Estonia from 6% to 2%. ■ Estonia also decided to use contributions from the second pillar to support public finances in such a way as to abolish state contributions to the second pillar from June 2009 to January 2010, however, providing for the possibility of private payments in the amount of 2%. ■ early in 2012, with the recovery of Estonia's public finances the old contribution system was restored: private contributions (2%) plus state contributions (4%). Last year it increased pension contributions from 6% to 8%.	

Sources: OECD, Raiffeisen RESEARCH

ideas completely opposite to the initially designed pension reform. The tampering with the second pillar by redirecting the inflow of funds from the second to the first pension pillar, which in itself is a form of nationalising pension fund assets with an objective to cover current pension expenses, represents an increase in the pension debt in the long run due to the increase in costs for future pensions.

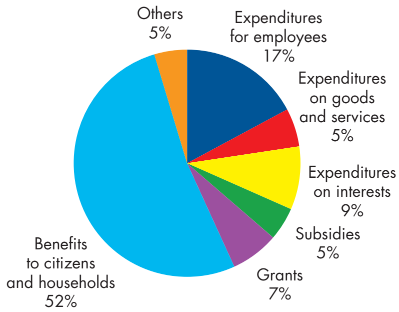
Here lies the danger of a short-lived illusion that a solution has been found in the form of covering the current budget deficit and of the temporary stagnation of the need for new borrowings. Such a transfer of assets from the second pillar[24] represents an implicit return to the PAYGO system which has long been abandoned as a dominant system for all of the above-stated reasons having to do with its inequitabilitay and financial unsustainability. However, instead of pressing ahead with pension reform which was supposed to go towards increasing the relative contribution to the second pillar (at the expense of the first pillar), we have witnessed the opposite ideas being implemented. In addition, it is worth noting that thus far the effects of the pension system reform have clearly outlined the positive role pension funds have had in the development of the financial market. Pension funds with their healthy returns, which are at the higher end in the region and Europe[25], have at the same time been the government's main financial partner. However, amid conditions of a heavy financial crisis in the public finances, reaching for capitalised assets at individual accounts of future pensioners represents an implicit increase in future public debt and heavier tax burden on citizens (which would be a new blow to domestic competitiveness). The final result is that in the future the amount of pensions will again become heavily dependent on the number of the employed and current economic situation in the country. This is why such one-off measures are especially dangerous for countries with falling birth rates (which Croatia undoubtedly is) because the expected drop in the number of active working-age citizens does not have negative implications on the second pillar but rather on the first pillar from which current pensions are paid out from the current contributions paid in by current contribution payment obligors. Therefore, risk diversification to three pension pillars in its core ensures greater social security and reduced risk in old age because insurance risks are divided among more levels and insurance carriers which should ultimately be more favourable and safer from the pension insurance depending only on current revenues from contributions based on generational solidarity. We find, from the point of view of future pensioners, that it is necessary to ask, how we could contribute more to the second and third pillar and finance current deficit by assets released from the rationalisation of unproductive public expenditures which have failed to show changes in their structure for years. A reduction of public borrowing that is not a result of actual structural reforms and public incentives to ideas of freezing and/or abolishing capitalised mandatory pension savings would result in a short-term alleviation of the high fiscal deficit syndrome, but would in the long run create long-term difficulties in the fulfilment of obligations towards future pensioners. Last but not least, the question arises of whether is it not high time to start behaving responsibly towards future generations?

Total revenues of the Central government, Jan–Sep 2014



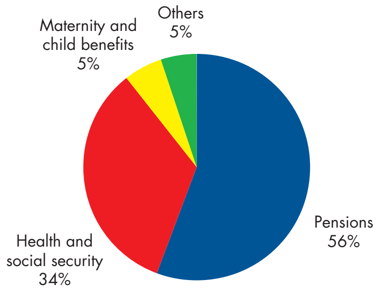
Sources: MF, Raiffeisen RESEARCH

Total expenditures of the Central government, Jan–Sep 2014



Sources: MF, Raiffeisen RESEARCH

Social benefits to citizens and households, Jan–Sep 2014*



** central government coverage*
Sources: MF, Raiffeisen RESEARCH

[24] In accordance with the ESA 2010 methodology, the European Commission treats such asset transfers as the so-called one-off items, which pursuant to its definition does not have the characteristics of budget revenues but of one-off receipts. Contrary to the methodology employed by the Ministry of Finance, budget revenues would not be increased by the amount of assets transferred from the second pillar, which means that the reported budget deficit would be increased by the same amount.

[25] More on returns of pension funds in the chapter ''Pension reform in Croatia''.

4. Pension funds in Croatia

4.1. Attitude of citizens and experts towards Croatia's pension system

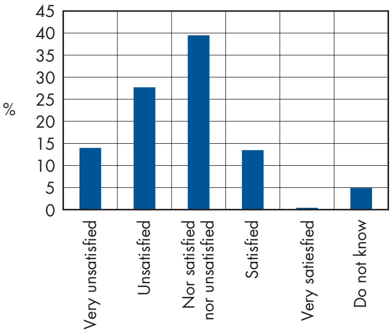
A survey conducted by the Ipsos Puls Public Affairs agency that was completed in July this year aimed to establish the current reputation and standing of pension funds in the Croatian society. The data on the attitudes of citizens and experts towards the pension system and its future provide a comprehensive picture of the views of current and potential pension system members.

The survey indicated that there is a **general consensus** among Croatia's citizens and experts regarding the situation in the pension system – they think the situation in the first pillar is alarming and its stability and future insecure at best. The key issue that came into the foreground when discussing Croatia's pension system was low, inequitable pensions which lead to reduced purchasing power and decreased standard of living after a person completes his or her active service and retires. Public opinion formers and experts recognised the following as the cause for the current situation in the pension system: the overlapping of the **economic crisis and the crisis of public finances** paired with rising pension costs; social policy that encourages retirement and withdrawal from the labour market, as well as the negative effects of the intertwining of early retirement and unfavourable demographic developments. Moreover, the survey indicated fears that a new wave of early retirement might be caused by stronger attempts to reform the public sectors because early retirement paired with stimulating packages might be used to lower resistance to public sector reform. At the same time, experts underlined a **series of positive effects of the pension system reform** visible thus far. At a symbolical level there is the message to citizens that they are responsible for their own future and standard of living in old age (deoarture from the socialist mentality pursuant to which the government is expected to provide for us); accumulation of substantial domestic savings and capital market development. Fund returns are stable and satisfying, exceeding initial expectations set at the onset of reform. They noticed that savings accumulated in the second pension insurance pillar have predominantly been used for lending to the government in the domestic market, while in addition to development of trading on the domestic capital marketwas generated to be use for investments and lending to Croatian companies for development projects[26].

The survey showed that Croatian citizens command a sound knowledge of the situation in the pension system (the above-average knowledge was demonstrated by older respondents, respondents with higher education and respondents with higher income)[27]. The qualitative survey reflected that beneficiaries/citizens think that it is still too early for the assessment of the quality of pension system reform since combined payments of pensions from the first and the second pillar have not been started yet.

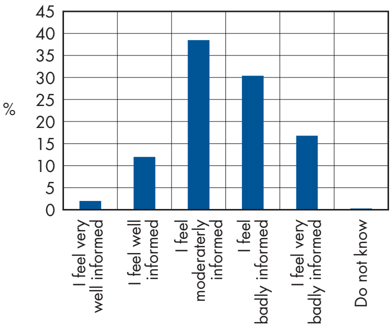
The survey also reflected that public opinion makers and experts consider pension reform as one of rare reforms that had been designed and initiated in ac-

About 42% of citizents are not satisfied with the Croatian pension system*



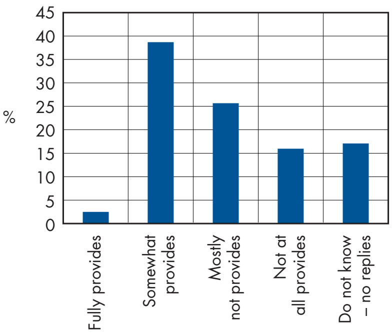
** survey question: "Generally speaking, how much are you personally satisfied with the pension system in Croatia?"*
Source: Ipsos Puls Agency

Self awareness of the pension system*



** survey question: "How would you assess your level of awareness of the pension system in Croatia?"*
Source: Ipsos Puls Agency

Attitude of the pension funds' members on the principle of justice*



** survey question: "Do you think that the concept of the pension system (through 1. and 2. Pillar) allows the realization of the principles of justice?"*
Source: Ipsos Puls Agency

[26] In addition to teaming up with banks, fund critics object to their sizeable investments in government bonds and too few investments in economic projects. They think the return on the share of the portfolio that is not invested in government bonds is to low and support the liberalisation of fund investment regulations.

[27] Persons with higher income more often think that the reform underpins the principle of equitability in the pension system.

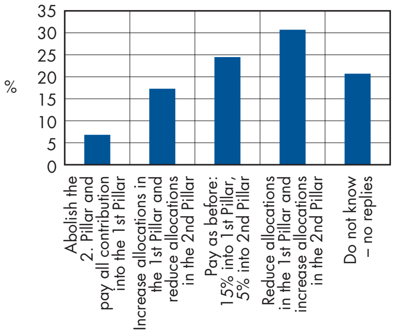
cordance with a clear model and had clear objectives but was not seen through. Given that the contributions ratio has not been changed over time in favour of contributions to the second pillar, the question arises whether the model makes sense without this change. The ultimate objective of the reform was to reduce pension dependence on the work of current generations. Various concessions to pensioners (debt repayment, introduction of pension supplements for new pensioners, changes in the indexation system, lacklustre transfer to the full time of service as the basis for pension calculation, etc) caused a regression towards a generational solidarity system. Political interventions and poor economic trends caused a much highr transition cost.

As for their attitude towards the continuation of the pension reform, the survey indicated that contributions to the first pillar should be reduced and contributions to the second pillar increased[28]. The prevailing opinion in the qualitative part of the survey as well was that the second pillar should not be abolished or its assets transferred to the first pillar. It was underlined that assets in question are personal assets on individual accounts and that such a move would be a nationalisation of sorts, or "theft" (such opinions are founded on the distrust in the honesty and capability of political elites in general, while the impact of such a move on the state budget was deemed as one-off and short-lived). Those against such a regressive intervention into the second pillar stated numerous arguments against it:

- Most countries carried out these second pillar interventions in order to complete the EDP faster. However, the European Commission did not accept such transactions as expenditure cuts.
- Returning to the first pillar would implicitly increase public debt toward younger generations which implies renewed increase in further taxation burden, heavier burden on citizens and decline in competitiveness.
- Such short term solutions only create room for abandoning key reforms which in the medium and long horizon are key for the stability of public finances.
- A revision of the pension system in the sense of a regressive intervention into the second pillar would not solve the basic problems such as the demographic situation and the unfavourable ratio of workers to pensioners.
- The transfer of assets from the second into the first pillar would consequently lead to the sale of pension fund assets. The transfer of these funds would mean the seizure of assets pension funds currently hold in their portfolios, which are to the greatest percentage government bonds. This would ultimately mean that these bonds would be sold off, having a negative impact on the country.
- *Ad hoc* political decisions and short-term interventions show that Croatia is neither a sufficiently mature democracy nor a sufficiently mature economy and that the principle of random reaching for money where there is some sends wrong signals to investors and savers.

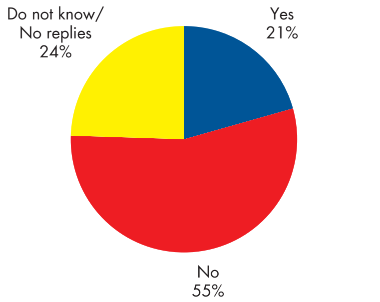
[28] The above-average percentage of well-educated persons, officials and persons with higher income is in favour of increasing contribution payments to the second pillar, while those in favour of abolishing it are more often older persons, persons with secondary education and income of up to HRK 3000. The majority of beneficiaries think that the contribution ratio should be 10%:10%, suggesting that there is strong support for developments in such a direction. More than a half of respondents would not support a decision to abolish the second pillar, while such a decision would be supported by approximately 21% of beneficiaries.

Relative majority of pension funds' members consider there is a need to reduce allocations in the 1st Pillar and increase allocations in 2nd Pillar*



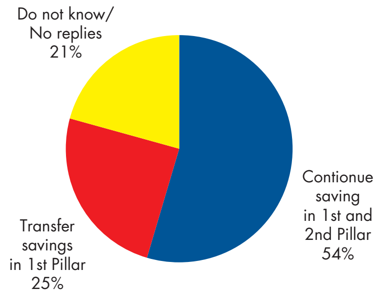
** survey question: "What do you think about current pension contribution allocation ratio"*
Source: Ipsos Puls Agency

Support of the 2nd Pillar abolishment*



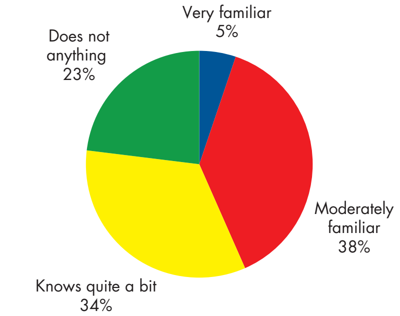
** survey question: "Whould you support the resolution of the 2nd Pillar abolishment or not?"*
Source: Ipsos Puls Agency

Half of examinees would continue to save as before*



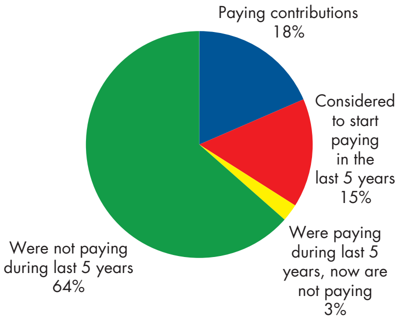
** Fund member's attitude on the possible fund transfer in the first pension pillar*
Source: Ipsos Puls Agency

Familiarity with pension fund performance*



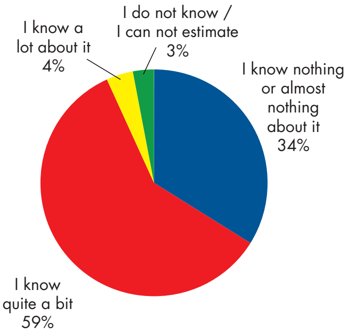
** survey question: "Generally speaking, how much are you familiar with the performance of your mandatory pension fund?"*
Source: Ipsos Puls Agency

Paying voluntary pension contributions – experience of the companies and ther intentions for future*



** survey question: "Does your company pays for all or part of employee funds in the voluntary pension fund?"*
Source: Ipsos Puls Agency

Familiarity with the 3rd Pillar*



** survey question: "How much are you personally familiar with the voluntary pension savings?"*
Source: Ipsos Puls Agency

4.2. Employers partaking in the voluntary pension system

Although the above-mentioned survey showed relative pessimism[29] of Croatia's citizens towards their retirement days and showed that annuity savings in banks are, in their view, the most attractive form of saving, they have recognised numerous advantages of **voluntary pension savings**. Regardless of trends, voluntary pension savings are the only financial product whose sole purpose is to save for retirement.

Members of voluntary pension funds underline higher pensions as the main reason for their membership, which is precisely the purpose of voluntary pension savings – to ensure ongoing social security and increase income in old age. Despite the fact that consciousness of the benefits of voluntary pension plans exists in principle, additional efforts should be made in order for its complete affirmation. This is the reason why further below in the text we go on to present the role of the employer in the voluntary pension system. It is our intention to point to a series of different advantages arising from voluntary pension system membership.

In almost all companies, employees are entitled to a certain form of supplement to their basic salary. However, only in rare cases this takes up the form of a contribution to a voluntary pension fund[30]. There is a substantial number of employers who are not informed about the reliefs arising from making payments to voluntary pension funds for their employees. In addition, the orientation of citizens towards their short-term financial needs and solving their current financial difficulties is not negligible. On the other hand, there is the prevailing lack of long-term planning which has also affected employers in a way that they prefer to pay out supplements and benefits to employees that meet their short-term financial needs.

Results indicate that close to one fifth of surveyed enterprises makes contribution payments to voluntary pension funds, 15.5% of them considered contributing to voluntary pension funds, while 2.5% have but no longer are making such payments. Further, close to one fifth intends to increase the rights of their employees, with voluntary pension savings being among their choices.

The most significant advantages arising from employer contributions to voluntary pension funds:

- Tax reliefs – employers can save considerably by utilising tax reliefs. Contributions of up to HRK 500 per month and per employee (HRK 6000 per year and employee) are recognised as tax reliefs. Contributions to voluntary pension funds enable employers to increase salaries without amending employment contracts or, for instance, pay out bonuses or part of, reward or keep key employees.
- Flexibility – employers are not obligated to pay contributions for all employees, or pay the same contributions for all employees. The contributions can be made at any given frequency, monthly or annually. The ceasing or the reduction of payments does not decrease the rights of fund members. All fund

[29] Almost a half of interviewed participants think their pension will be 20% to 50% lower than their current income.
[30] The survey showed enterprises think that from employee perspective best reaction is to the 13th salary, holiday and Christmas bonus, while contributions to a voluntary pension fund are somewhere in the middle among preferred benefits.

members enjoy equal rights, and assets are always and under all circumstances personal property of fund members.

- No restrictions for membership – a voluntary pension fund member can be everyone, irrespective of their age, health or citizenship.
- State subsidies – the government provides an incentive for saving with a voluntary pension fund with a state subsidy in the amount of 15% of all yearly contributions up to the maximum of HRK 750 per annum. The payment to all individual accounts which registered contributions to a voluntary pension fund within a calendar year is carried out once a year.
- Easy access – the sole condition for access to individual savings is to reach 50 years of age. Members can choose between a one-off payment of 30% of saved assets and receiving the rest in the form of a pension over the agreed period (let us say five years) or until their death.
- Heredity – the contributed assets are inherited.
- Transparency – members of voluntary pension funds can at any given time obtain data and information such as data on the balance in the individual account, fund returns, the amount of fees charged. Members can also, at any given time, change personal data, frequency of contribution payments, obtain information on payment options, opt for payments through a fund[31] or payment insurance company.
- Yields – returns yielded by a voluntary pension fund increase the value of savings in the individual account and constitute part of the assets.

In order to illustrate the impacts of voluntary pension savings on employers and show the use of tax reliefs, an overview of several basic models of contribution payments to a voluntary pension fund and various salary combinations is given in the text below.

a. Give a raise or make contribution payments to a voluntary pension fund?
Employers who want to reward or keep key employees may increase their salaries or make contribution payments to their voluntary pension fund. Here is a comparison of these two possibilities. For example, if the employer increases the salary of an employee who has a gross salary of HRK 10 000 by HRK 500, the expense for the employer will go up by HRK 586 (gross 2), while the employee's net salary will go up by approximately HRK 280 (Table 1).

Table 1:

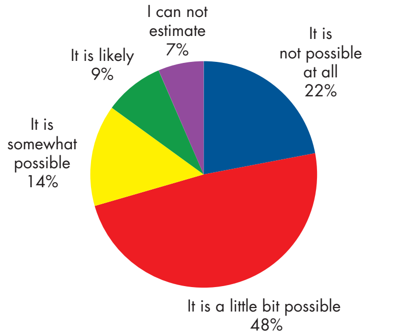
HRK	Initial balance	Gross increase by HRK 500	Final balance
Gross salary	10,000.00	500.00	10,500.00
Average net salary*	6,744.48	282.00	7,026.48
Total cost	11,720.00	586.00	12,306.00

surtax 18%, personal deduction HRK 2,600

If the employer decides to make a contribution payment to the employee's voluntary pension fund in the amount of HRK 500, the cost of the payment would amount to HRK 500, HRK 86 less than the increase in gross salary, and the employee would receive HRK 500 to a personal account with a voluntary pension fund. He or she would also receive a state subsidy of 15% per annum and fund yield (Table 2).

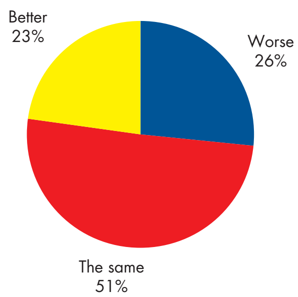
31 Payments through voluntary pension funds will be possible after legislative adjustments in 2015.

Perception of intent to start paying into 3rd Pillar*



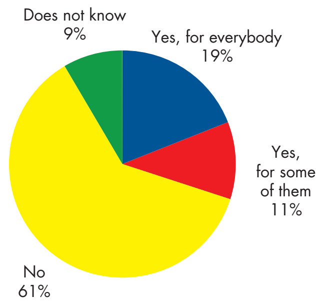
** survey question: "How likely is that your company will decide to start paying contribution to its employees based on this information?"*
Source: Ipsos Puls Agency

Expectations for pension fund management in the future*



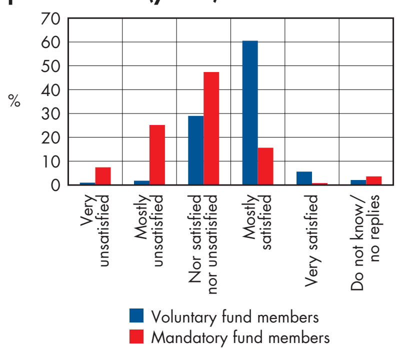
** survey question: "What do you think about the future of the Pension Fund management? Is it going to be worse, better or the same successful as it is now?"*
Source: Ipsos Puls Agency

Plans to increase the employees' rights*



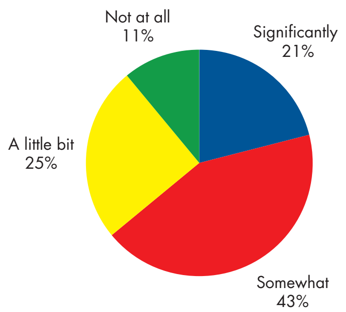
** survey question: "Does your company plan to increase employees' rights or salary within the next 12 months? / If yes, how and for whom?"*
Source: Ipsos Puls Agency

Satisfaction of voluntary funds' performance (yields)*



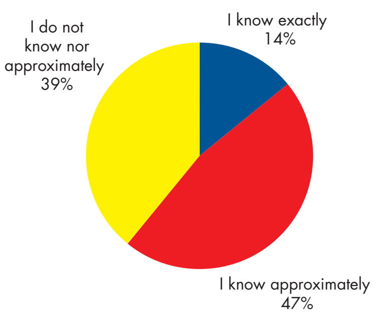
** survey question: "Are you satisfied with yields your voluntary pension fund achieves?"*
Source: Ipsos Puls Agency

Employees' motivators*



** survey question: "Does voluntary pension contribution (3rd Pillar) that company pays for employees raise employees' motivation?"*
Source: Ipsos Puls Agency

Familiarity of pension fund members with pension account balance*



** survey question: "Do you know your current pension account balance?"*
Source: Ipsos Puls Agency

Table 2:

Uplata u Fond 500 HRK		Povećanje bruto plaće 500 HRK	
Employee	**HRK**	**Employee**	**HRK**
Assets in the fund	500.00	Gross salary	10,000.00
State subsidy	62.50	Increase in gross salary	500.00
Total assets in the fund*	562.50	Increase in net salary	282.00
Employer		**Employer**	
Cost	500.00	Cost	586.00

**this calculation does not include the return yielded by a voluntary pension fund*

Conclusion: employees can be given more money at lower cost when opting for payments to voluntary pension fund accounts.

b. Net salary reduction can be combined with voluntary pension fund contribution payments

An employer who wants to save money on salaries and maintain employee satisfaction can combine this move with contribution payments to voluntary pension fund. For example: a net salary cut of HRK 500 and redirection of these funds to private accounts with voluntary pension fund of employees will cut salary costs for the employer by approximately HRK 1 040, while the employee will ultimately receive capitalised assets and state subsidy (incentives) (Table 3).

Table 3:

HRK	Initial balance	Gross salary cut of HRK 500	Final balance
Gross salary	10,000.00	–886.52	9,113.48
Average net salary*	6,744.48	–500.00	6,244.48
Total salary cost	11,720.00	–1,039.01	10,680.99

**surtax 18%, personal deduction HRK 2,600*

Conclusion: if the employer wants to keep employee satisfaction a HRK 500 contribution payment can be made to an employee's voluntary pension fund account. This way the employee would keep his or her HRK 500 but at a personal voluntary pension fund account. This amount would be capitalised and increased with time. The total cost for the employer in this case is HRK 500, with a HRK 1 040 being saved in salary expenses resulting in a positive balance for the employer (totalling HRK 539). The employee's assets are capitalised at his or hers personal voluntary pension fund account and are increased by the fund return and the amount of state subsidy, while the employer benefits from substantial savings due to tax reliefs on contribution payments to voluntary pension funds. The effects are positive for both the employee and the employer in this combination. Money saved by the employer who decided to cut net salaries of employees by HRK 500 and make contribution payments in the same amount to a voluntary pension fund instead can be substantial. For example, in a company with 50 employees, money saved in monthly terms can reach approximately HRK 27 000 and in a company with 200 employees the figure exceeds HRK 100 000 per month (gross salary of all employees in this example is HRK 10 000).

c. Combining gross salary cuts with voluntary pension fund contribution payments – in the interest of employees

In agreement with an employee the employer may redirect HRK 500 of the gross salary to a voluntary pension fund. In this case, salary expenses of the employer would decrease by HRK 586 (Table 4).

Table 4:

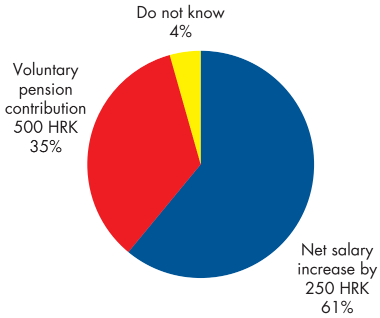
HRK	Initial balance	Gross salary cut of HRK 500	Final balance
Gross salary	10,000.00	–500.00	9,500.00
Average net salary*	6,744.48	–282.00	6,462.48
Total salary cost	11,720.00	–586.00	11,134.00

**surtax 18%, personal deduction HRK 2,600*

Conclusion: the contribution payment to the voluntary pension fund account decreases the employee's salary by HRK 282, he or she has HRK 500 on his or hers personal voluntary pension fund account and is entitled to fund returns and state subsidy. From the perspective of the employee, he or she saved HRK 500 at the cost of HRK 280. The money saved by the employer in this case is HRK 86, resulting from the difference between the cost of the employee's gross salary 1 and gross salary 2.

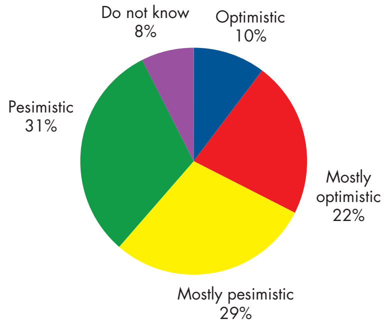
In general, we may conclude that the primary objective of the third pillar, the voluntary pension system is to ensure additional capitalised assets available to the beneficiary at the time of retirement. This way the insured person through his or her own contributions (together with fund returns and state subsidies) reduces the dependence of the amount of his or her pension on some future state budget.

The preferred form of salary increase*



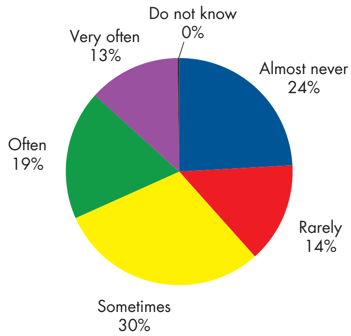
** beneficiaries of pension funds*
Source: Ipsos Puls Agency

Expectations of pensions*



** survey question: "How do you look at the part of your life when you will be retired?"*
Source: Ipsos Puls Agency

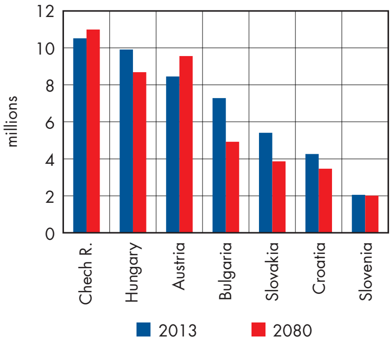
Thinking of retirement days*



** survey question: "Do you think of retirement as part of your future life?"*
Source: Ipsos Puls Agency

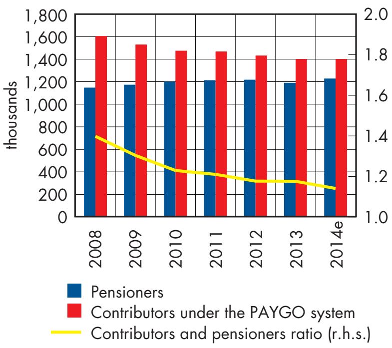
Conclusions and recommendations

Population projections 2013 – 2080



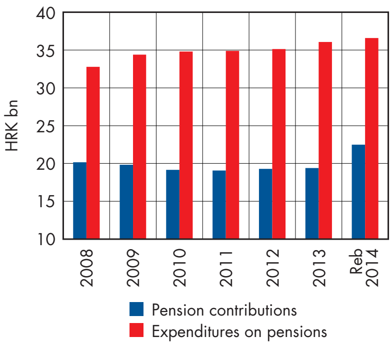
Sources: Eurostat, Raiffeisen RESEARCH

Pension beneficiaries and contributors



Sources: CPII, Raiffeisen RESEARCH

Current revenues from person contribtions and expenditures on pensions*



** transferred funds from the II pension pillar are included in revenues from contributions in 2014*
Sources: MF, Raiffeisen RESEARCH

The golden age of welfare state enjoyed over the past decades is gone all across Europe. Population aging causes demographic changes that jeopardise pension systems in the long term. The problem of their sustainability was additionally exacerbated by the global financial crisis that was set off in the US in 2007 and then spread the economic and fiscal crisis to Europe, strongly affecting the social standard of the population. Similarly as many other European countries, in the last three decades Croatia has been faced with a deteriorating situation in its public pension system, which is, generally speaking, marked by three key factors: demographics, economic developments (primarily in the labour market) and regulatory developments. Negative demographic trends (declining birth rate, increased life expectancy, etc.) have led to depopulation and accelerated population aging. The ratio of the number of the insured to the number of pensioners has been deteriorating for years. It has received additional hits from the effects of the post-war transition period of the 1990s. The unsuccessful privatisation process that resulted in the loss of jobs and failure of non-restructured companies paired with consistent lack of strategically well-conceived economical policy measures had a strong negative effect on Croatia's pension system. The failure of economic policies and a short election cycle marked the period with generous (early) retirements because social difficulties have often been solved by avoiding painful structural reforms, which in the short run created an illusion of eliminated pension deficit.

The pension reform of 2002 has been envisaged as a (re)distribution of responsibility for future pension payments, at the same time raising the consciousness of the importance of individual approach to the problem of risk associated with old age. In addition to the implementation of the second and third pillars, designed to meet the objectives of the pension system reform, over the years we have witnessed partial interventions in the system of which some have undoubtedly constituted a step back relative to the initially envisaged reform. One such intervention is the change in the pension system contributions arising from accelerated pension plan which enabled members of mandatory pension funds to withdraw their assets, i.e. transfer their capitalised assets from the second pillar into the state budget. As the example of other countries, it should be noted that the government can not transfer the funds from the second to the first pillar by any discretionary decision (because the funds are individual capitalized accounts of the fund members constitutionally protected). As a rule, it is a voluntary decision of each individual but motivated by different measures of the policymakers. Unlike mandatory (first and second pillar) the voluntary pension pillar is free of such "creative solutions". Namely, the funds in the third pension pillar can not be used for any purpose other than payment of pensions to members who have voluntary contributed to the fund in order to reach higher social security protection in old age.

The example of Hungary[32], which practically abolished its second pension insurance pillar, shows that this can truly render current problems in the pension system less painful. Namely, the fiscal effect of a one-off transfer of assets from the second pillar into the first, generational solidarity pillar (as a form of nationalisation of personal assets in the example of Hungary) create an illusion of a temporary solution which neglects the time dimension of pension entitlements and

32 In Hungary 2.9m (of the total 3m) of pension fund members ''opted" to return to the 100% state PAYGO system.

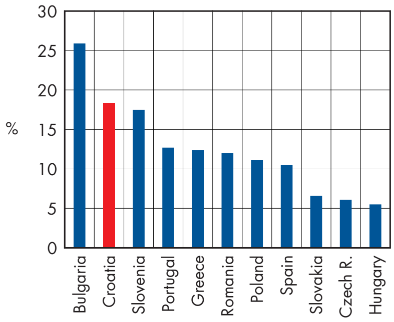
obligations. The currently ensured capacity to ensure current pensions leaves a misleading populist impression with current pension beneficiaries, also implying a substitution of sorts for current government borrowing to cover the current pension deficit. Hypothetically, one can speak of a transition cost refund. However, the main flaw of such regressive pension system measures is that they leave behind an unjust system for future generations who thus loose the opportunity to themselves ensure their own higher (capitalised) returns by making contribution payments to the second pillar to fall on when they themselves become beneficiaries of their pensions. In contrast, the "Hungarian" model leaves persons currently insured to take care of current pensioners under the principle of generational solidarity, while the future of their own pensions remains in the shadow of the relative increase in the number of future pensioners, whose pensions will depend on the economic situation in the national economy at some future moment. Given that all projections indicate further decline in the ratio of persons insured to persons retired, a logical conclusion can be drawn that such a measure of **abandoning the second pillar** undoubtedly leads to higher pension debt in the future or an alternative increase in the tax burden on the future active working-age population. From the aspect of public finances, these types of interventions in the pension system may result in entirely different budgetary distribution which reduces potential economic growth in the future because relatively higher budget expenditures need to be channelled into servicing obligations for pension payments (instead of channelling them into more productive public expenditures).

A somewhat less radical measure such as **the reduction of the relative contribution rate to the second pillar** (as in Poland) also represents a step back of sorts towards the unsustainable PAYGO system. However, continued strong growth of pension expenses constitutes a first rate socio-economic question that implies the growth of fiscal deficit and consequent growth of public debt. As a result, amid unsustainable developments in public expenditures different countries reach for different models of dipping into the capitalised individual savings of their citizens. In case of Poland, the rate of contribution to the second pillar was reduced and the difference redirected into the generational solidarity pillar. After a year the contribution rate to the second pillar was raised again, which was in the end redefined as a voluntary pension pillar. However, it is noteworthy that Poland introduced a new provision to its constitution, limiting its public debt, which constitutes a statutory constraint for the transfer of public debt burden on future generations of Polish citizens, to the maximum tolerable rate of 60% of GDP.

Estonia opted for (temporary) **freezing of contribution payments to the second pillar**. However, the Estonian government, obviously aware of the implications on future state budgets, restored the contribution payments to the second pillar after the temporary fiscal consolidation. Moreover, after having used the move as a short-term fiscal aid, it increased the contribution rate to the second pillar from 6% to 8%.

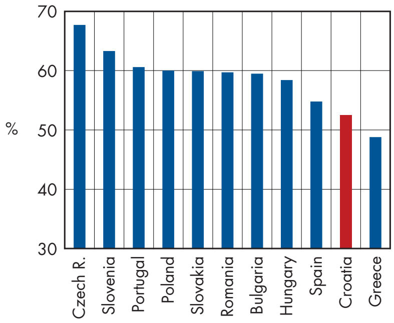
Croatia, as a high-risk country, whose risks arise from exceptionally negative demographic projections, not to mention which is plagued by systematic lack of structural reform, is suffering a difficult and long phase of economic slowdown. Six successive years of recession caused considerable disturbances in the labour market which in turn led to the excessive rise in the public pension system deficit. Maintaining the **status quo** would mean abandoning the initiated pension reform

At-risk-of-poverty rate for pensioners, 2013



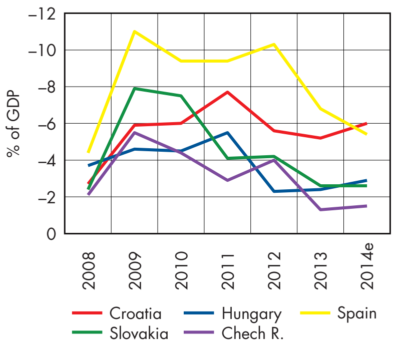
Sources: Eurostat, Raiffeisen RESEARCH

Employment rate in 2013 (15 to 64 years)



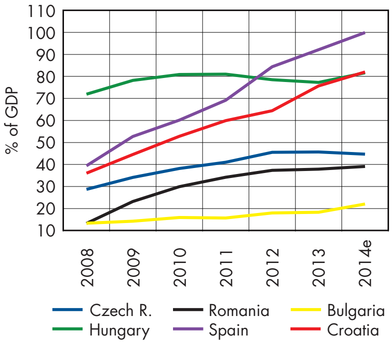
Sources: Eurostat, Raiffeisen RESEARCH

Consolidated General Government Deficit as % of GDP (ESA 2010)



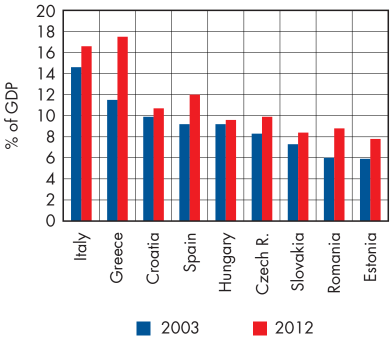
Sources: Eurostat, Raiffeisen RESEARCH

Total Public Debt as % of GDP (ESA 2010)



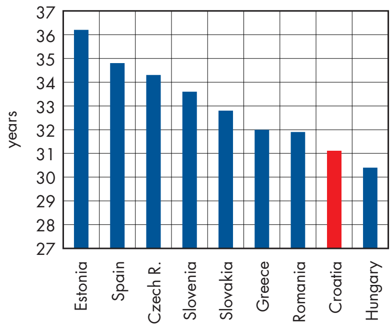
Sources: Eurostat, Raiffeisen RESEARCH

Expenditures on pensions



Sources: Eurostat, Raiffeisen RESEARCH

Duration of working life, 2012



Sources: Eurostat, Raiffeisen RESEARCH

aimed primarily at restoring long-term balance between equitable pensions and financial sustainability of the pension system as a whole. We are witnesses of unsustainable state of public finances, with cumulative budget deficits accounting for the worrying dynamics of public debt growth. Under the influence of external pressures towards stronger fiscal consolidation, required under the EDP procedure, Croatia opted for one-off measures of reducing the current pension deficit by transferring the capital assets from the second pillar (for the portion of persons insured under the accelerated retirement plan) into the state budget. The sizeable, one-off effect has been achieved. The government has not been forced to borrow or finance a share of pensions by non-purpose tax revenues. According to the government plans, this will be repeated once more in 2015. Then elections are due and new promises will follow. This time they should especially target voters as future pensioners.

In the meantime, a deep analysis of public expenditures is under way. We sincerely hope it will show real room for saving (shrinking of an oversized public sector and channelling of unproductive public expenditures into development-oriented that would generate real economic activity and new jobs). Under this scenario, the **option of active continuation of the pension reform** could be deliberated again. Instead of interventions in the form of transfer of capitalised assets from individual accounts of insured persons it is high time to deliberate the possibility of raising the contribution rate to the second pillar of the mandatory pension system. The pension policy as the most important component of the overall fiscal policy cannot be rash but has to be well-conceived and, as a rule, long-term oriented. Given the need to take care of the financial sustainability of the pension system and equitability of pensions at the same time, it is necessary to work in all areas at the same time: stimulate work and employment within the framework of all economic measures and policies, strengthen the link between contribution payments and future pensions which stimulates longer stay in the labour market, while the pension indexation and valorisation system needs to be fiscally sustainable. The financial balance of the pension system assumes the reduction of its dependence on transfers from the state budget. This equation can be solved only in two ways: by increasing the volume of income from payment contributions and/or reducing the volume of pensions. Given the pension equitability requirement, the volume of pensions can be reduced by detailed review, i.e. correction of procedures in which rights to privileged pensions were given, through penalisation of early retirement, etc. At the same time, the increase in the volume of contributions should not be achieved by increasing the contribution rate in order not to disrupt competitiveness. Instead, efforts should be made towards increasing the base, i.e. the number of the employed.

This leads to the conclusion that the division of burden to ensure equitable pensions between the state budget and insured persons themselves is the option having the best chance of success in the long run. The coverage of rising current fiscal deficit should be ensured by the entire spectrum of known consolidation measures in order to make it easier for future generations to finance an exceptionally high number of pensioners due to the fact that this figure is on the rise according to all projections and will further deteriorate the already unfavourable ratio to the number of the persons insured. The strengthening of individual savings with the second and third pension pillars should be the choice which exceeds the framework of just one political mandate.

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Abbreviations
ACHWV – The Act on Croatian Homeland War Veterans
AMP – Active Military Personnel
AO – Authorized Officials
bn – billion
CASA – Croatian Academy of Sciences and Arts
CBS – Central Bureau of Statistics
CDC – Croatian Defence Council
CES – Croatian Employment Service
CFSSA – Croatian Financial Services Supervisory Agency
CPII – Croatian Pension Insurance Institute
e – estimate
EDP – Excessive Deficit Procedure
ESA – European System of Accounts
EU – European Union
Eurostat – European Statistical Office
GDP – Gross Domestic Product
ILO – International Labour Organization
kn, HRK – Kuna
LRCHWV – The Law on the Rights of the Croatian Homeland War Veterans
mn – million
MF – Ministry of Finance
MPF – Mandatory Pension Fund
MP – Military Personnel
OG – Official Gazette
PIA – The Pension Insurance Act
PAYGO – “Pay-as-you-go” system
PO – Police Officers
SFRY – Socialist Federative Republic of Yugoslavia
YNA – Yugoslav National Army

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