

THE POLITICAL ECONOMY OF PENSION REFORMS IN CROATIA 1991-2006

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Abstract

After the collapse of ex-Yugoslavia, Croatia inherited a 'premature' socialist pay-as-you-go pension system. During the early 1990s, it was used more extensively than elsewhere in Central and Eastern Europe to ease the pains of the country's transition to a market economy, thereby leaving Croatian pensions in dire need of reforms. This article will try to meticulously describe the reform process during the period 1991-2006, which was characterised by three relatively independent phases: the first, a retrenchment phase, which condemned a majority of pensioners to old-age poverty; the second, a restructuring phase, which led, under the aegis of international financial institutions, to the legislation of radical reforms; and the third, a populist phase, which undid most of the previous efforts. The article will conclude that this concoction of poverty, agency capture and crony capitalism had a common denominator, that is the struggle for power during the country's democratic consolidation.

Keywords: Croatia, institutional change, multipillar pension systems, pension reforms, populist measures

"Why are you sticking to the rules like a drunk to a lamppost"?

Josip Broz Tito

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1 Design and hypotheses

1.1 Basic design and regulation of the system in 2007

The Croatian pension system in 2007 is a good representative of the hybridisation process that occurred in the Nordic (and Central European) cluster (Natali, 2004:19-20). Croatia relies now on a multipillar structure, based on the classic World Bank 1994 recipe. However, interesting incongruous elements are present within the country's system, which has created vast political problems.

The first pillar is pay-as-you-go (PAYG) and maintains actuarial fairness through the use of a 'German point system', an advanced defined benefit (DB) formula based on life-time earnings. A second, mandatory funded pillar was carved out from the first one and rendered obligatory for insureds below 40 and optional for those aged between 40 and 50. The third is instead voluntary and comprises individual as well as occupational schemes. Therefore, two systems (the old PAYG and the new multi-pillar one) have co-existed in Croatia since 2002.

Behind this apparently spotless façade lie a number of unresolved issues, which are related to the socialist and early Croatian Democratic Union (HDZ) inheritance as well as to insufficient courage in tackling reform details.

The greatest problem burdening the Croatian pension system is the extremely unfavourable system dependency ratio (SDR), which reached its nadir at 1.36 in 2000¹, thereby rendering fiscal sustainability impossible without a drastic reduction in replacement rates. The net replacement rate was 37.62 in 2000, breaching ILO Convention 102 and meaning that some 700.000 pensioners were close to abject poverty. The situation will not improve until the 2nd pillar becomes fully operational and thus a bitter dispute over a presumed discrimination between 'old' and 'new' pensioners erupted during the 2007 pre-electoral period.

Moreover, it is questionable whether the funded pillar will resolve anything at all, given the low contribution rate of 5%. The World Bank originally planned to raise it over time, as with Hungary, but Finance Minister Borislav Škegro, who feared the ensuing transition costs, blocked the attempt (Anušić and Mintas Hodak, interview). Only now is the executive timidly rethinking this strategy (Vlada RH, 2006:48). However, low contributions are only one problem afflicting the second pillar. Administrative fees are high, competition is limited, investment limits are too stringent and naturally bounded by an underdeveloped capital market. The lack of tax deductions for employers in the third pillar does not help. In addition, as will be extensively shown, the system continues to be vulnerable to special interest group demands and captures, and no current political coalition is capable of unshackling it.

Thus the Croatian is a troubled system, which leads us to a concoction of poverty, trampling of fundamental rights, agency capture and crony capitalism, which have as a common denominator the struggle for power during the country's democratic consolidation.

¹ Some claim that the actual SDR was even lower: 1.00 taking account of employees whose firms failed to pay salaries, 0.70 if redundant workers are excluded (Marković, 1999). Of course, these extreme values are not demographically generated, they are mainly the result of an inconsiderate early retirement policy, which only the 1998 Pension Insurance Act (ZOMO) managed to stop.

1.2 Hypotheses on the development of the system

The tale of Croatian pension reforms is not only one of failed starts and major delays, but also of deep politicisation of the pension issue and its instrumental use for solving major public finance problems and thereby its inability to fulfil its basic task of providing social security to the elderly.

Starting with a premature Yugoslav PAYG system and an underdeveloped economic situation, Croatia legislated a radical multipillar reform. Deep financial crises delayed its implementation, giving a misleading impression of gradualism, whereas reforms were at times brutal to losers (Županov, 1996) and mostly captured by winners. The reform approach was elitist and imposed: social partners experienced ‘dialogue’ as ‘instructions’ and ‘external conditionality’ as ‘a dictate’ (Maršić, 2004:87-88).² Notwithstanding, Carana Corporation (Hurd, 2003:3) labelled the final result as a “*tremendous success and one of the best reforms in Croatia to date*”.

Changes were discontinuous, but can be grouped into three main phases.

The first one was a sweeping attempt at retrenchment enacted within the 1993 stabilisation package. While ineffective due to concomitant populist measures, it pushed most of the retired population into abject poverty. These unilateral cutbacks prepared the stage for a controversial Constitutional Court decision, which set in motion mechanisms of such perversity as to be still, ten years after, distracting Croatian politics from the more pressing problems of the country.

The second phase was the result of much involvement by international financial institutions and it encompassed a major overhaul of the Croatian pension system with the 1998 Pension Insurance Act (*Narodne Novine* – Official Gazette, NN, 102/98), the 1999 Compulsory and Voluntary Pension Funds Act (more briefly the Funds Act; NN 49/99) and the subsequent Annuities Law (OG 106/99). The three acts retrenched the PAYG system and introduced two supplementary funded pillars. Implementation followed much later – in June 2002 the new regime officially started operating – which is telling about the preparedness of Croatia for a capitalised scheme. The end result was admittedly shaped upon World Bank recommendations, which had supported a partial privatisation since late 1995 (Rismondo, 1997). Technically, the paradigmatic shift was impeccable; socially, it was altogether another story.

The last phase is characterised by a losers’ backlash, a rupture in the established path departure (Aleksandrowicz, 2006). After three pensioners’ associations signed a social agreement granting electoral support to the Social Democratic Party of Croatia (SDP) and the Croatian Social Liberal Party (HSLs) before the 2000 elections (Matković, 1999e) and after the Croatian Pensioners Party (HSU) entered the governing coalition with the HDZ in late 2003 (HSU, 2003), the reversal of some reform measures became firmly entrenched at the top of the agenda. During implementation, the Croatian state proved too weak to react to interest groups’ multiple captures. It is admitted that reform outcomes are jeopardised.

² However, opinions on the quality of concertation vary substantially, see later paragraphs.

The chapter will be structured as follows. First, the chronology of pension system reforms will be presented with a strong emphasis on implementation.³ The latter officially started in January 1999 and witnessed the consolidation of vested interests originating outside – the financial and grey lobbies – and within the state – parts of the public administration and narrow electoral constituencies. These pressures will be analysed and the main actors will be dissected in the second, dedicated part of the chapter. The narration will reveal how the power of the executive, or better, the lack of it was ultimately responsible for the degeneration of implementation in Croatia.

2. Evolution of the pension system

While Croatia shared up until 1990 all Yugoslav federal legislation, some legal differences persisted, since federal laws set guidelines rather than firm rules and it was up to individual republics to adapt them to specific needs. Another point of departure was the radically different gross social product (GSP) rates marking the republics' different levels of development. In addition, contingent events, such as the Homeland War and the HDZ rule, delineated a drastically distinct transition in Croatia. Pensions reflected this accordingly.

2.1 The Croatian troubled transition

Croatian transition challenges were, before the collapse of the Yugoslav federation, similar to those of other self-determining post-socialist states (democratisation, marketisation, independence and creating a national from a regional economy); however, the ethno-nationalist struggle marked the involution that Croatian economics and politics underwent during the period running from independence, on 25 June 1991, until the electoral defeat of the HDZ in early 2000.

Transformation was at its inception characterised by an 'endogenous transition' or a '*ruptura pactada*', as the League of Communists of Croatia (SKH) introduced multiparty politics in December 1989. However, Serbian nationalism managed to steer Croatia clear of this course. The founding elections saw the nationalist and populist HDZ opposed to the SKH-SDP (Party of Democratic Changes), the SKH successor. HDZ prevailed due to two main factors: a) the party embodied Croatian historical radicalism and its leader and founder, former Yugoslav National Army general and nationalist dissident Franjo Tuđman, staunchly stood against Serbian hegemony, thereby appealing to the Croatian majority and deliberately seeking the support of émigrés; b) the opposition was weak; the SKH-SDP was deeply split between reformers and dogmatists and hence did not appear to be credible, since on the one hand it advocated democratic reforms and, on the other, bet on the federation's survival to attract non-Croatian voters (Zakošek, 1997).

The April-May 1990 elections witnessed a landslide victory by the HDZ, which took power on 30 May. A communist single-party regime was replaced by an anti-commu-

³ 2002 marked the 80th anniversary of pension insurance in Croatia, and for this purpose the edited book '*80 godina mirovinskog osiguranja u Hrvatskoj*' (80 years of pension insurance in Croatia) was published by the Croatian Institute for Pension Insurance (HZMO). Without it and without the help of its editor, Mihovil Rismondo, delineating the transition of the Croatian system from socialism to the present would have proved almost impossible.

nist single-party government. The newly established ‘ethnic-nation state’ soon degenerated towards an institutionalisation of the nationalist movement and concomitant de-institutionalisation of the governing apparatus, or better its confusion with the HDZ. A ‘hybrid regime’ that defied categorisation was created (Grubiša, 2002: 33-36; Kasapović and Zakošek, 1997: 27-29). The election of Tuđman as president of Croatia, the outbreak of the Homeland War and the triumphant operation *Oluja* only strengthened the HDZ position. This pushed Croatia into a phase of authoritarian regression. It took almost a decade for the SKH-SDP, renamed the Social Democratic Party of Croatia (SDP) in April 1994, to reorganise and win an election in coalition with the HSLS.

In the corporatist arena, the involution was similarly drastic. The HDZ’s authoritarian style was based on an *aut aut* to the old elites: cooptation or exit. This meant a complete disruption of the already weakened social dialogue, which only by 2001, under the SDP, saw a resurgence, with the conclusion of the Agreement on the Economic and Social Council and other forms of social partnership. However, the general opinion of trade unions is rather negative, as the government avoids responsibility, does not consult or enter into real negotiations and presents already drafted laws. By the same token, the idea of constructive social partnership was wiped out during the 1990s, also due to the Labour Code which permits the establishment of a trade union or employer association with just ten members. Trade unions are thus very fractioned and loosely divided into six representative confederations:

Table 1 Croatian trade union confederations in 2004

Name	Acronym	Reported membership in 2004
Union of Autonomous Trade Unions of Croatia	SSSH	211,205
Association of Croatian Public Service Unions	MATICA	55,830
Independent Croatian Unions	NHS	91,000
Croatian Trade Union Associations	HUS	40,000
Association of Workers’ Trade Unions of Croatia	URSH	60,000
Trade Union of Services	UNI-CRO	20,099

Source: CARDS (2005:50-72)

Considering the adverse conditions – the war and the international embargo – the Croatian economy was relatively successful, apart from its underwhelming employment record. By 2000, 80% of state owned enterprises (SOEs) were privatised, hyperinflation was eliminated by late 1993 and some structural reforms were successfully carried out (price liberalisation, introduction of VAT, major pension reforms). Even the two macroeconomic crises were dealt with satisfactorily. However, Croatia was seen as an international pariah, because it developed endemic and systemic crony capitalism, which allowed for state capture, rent-seeking and misallocation of resources (Bićanić and Franičević, 2003:14-23).

These two authors claim that the causes for this involution are to be found in both the institutional inheritance of Yugoslavia (state paternalism, the collapse of vital markets)

and wrong policy choices, sometimes backed by international financial institutions, such as too tight monetary policy and fixed exchange rates. In the end, crony capitalism was self-defeating as it started generating decreasing returns for both the population (through continuous crises and recession) and tycoons (by not providing secure property rights). By 2000 its delegitimation was complete and the expected performance betrayed, thereby providing opposition parties with a credible anti-platform upon which to base their electoral campaign.

2.2 From the old system to the 1993 stabilisation package

The consolidation of self-management and decentralisation in Yugoslavia deeply affected Croatian pensions via the 1982 federal Pension and Disability Insurance Fundamental Rights Act and its republican counterpart, the Pension and Disability Insurance Act (PDIA), which entered into force in July 1983. Croatian pension and disability insurance was organised into three ‘self-managed communities of interest’ for: a) workers; b) self-employed artisans, caterers and carriers; c) self-employed farmers.⁴ On 15 October 1990, as a consequence to the amendments to the Croatian Constitution, the communities were re-established and renamed Republican Funds (Rismondo, 2002: 64-74).⁵ Of these, the Workers’ Fund was by far the largest.

Table 2 Membership of Republican Funds in 1998

	Insured	% structure	Beneficiaries	% structure	SDR
Workers’ Fund	1.228,576	86.67	868,131	90.87	1.42
Self-employed Fund	80,021	5.65	20,226	2.12	3.96
Farmers’ Fund	108,912	7.68	66,995	7.01	1.63
Total	1.417,509	100.00	955,352	100.00	1.48

Source: Ott (2001:66).

As in the rest of Yugoslavia, benefits were calculated on an individual basis, thereby permitting a greater dispersion of income. The system was financed by employer and employee contributions; and the Croatian budget assumed responsibility for expenditures previously paid by the SFRY budget (for combatants in the National Liberation Struggle, personal achievements and the police), newly established merit pensions (see Tab. 5), all of which caused growing deficits in the funds. Therefore, in principle the successors of the Yugoslav pension system were lavishly Bismarckian and in great need of a thorough rethinking of their incentive structure. Since the ageing of the Croatian population was not the primary concern, a timely tightening of all eligibility criteria would have probably prevented the collapse.

⁴ The latter two were rendered autonomous in 1969 and 1980, respectively.

⁵ For simplicity, until the merger of the three into HZMO in 1999, the acronym RFMO – *Republički fond mirovinskog i invalidskog osiguranja radnika Hrvatske* – will be used for the Croatian Workers’ Pension and Disability Insurance Fund.

Notwithstanding this, by November 1995, no serious discussion on reforms had been undertaken. Quite the contrary, the pension system was abandoned to the arbitrariness of policymakers, who (ab)used it as a populist favour-granting cashbox and simultaneously crushed it to alleviate the fiscal imbalances of the Croatian budget. Thus, the Workers' Fund witnessed two opposite trends: a massive increase of pension expenditures and, simultaneously, a collapse in average replacement rates.

2.2.1 The pensioner stampede

Social security populism was not the most vicious bane of the Croatian pension system. The chief problem was the severe recession following the Yugoslav break-up and the ensuing Homeland War, which brought the whole economy to its knees. Unemployment, especially among men, increased dramatically.

Table 3 Unemployment in Croatia (in thousands)

Year	1989	1990	1991	1992	1993	1994	1995	1996	1997
Total unemployment	139.9	160.6	253.7	266.6	250.8	243.3	240.6	261.0	277.7
Female unemployment	83.4	91.4	133.0	141.3	138.4	130.5	124.2	129.6	137.3
Year	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total unemployment	287.8	321.9	357.9	380.2	389.7	329.8	309.9	308.7	291.6
Female unemployment	149.3	169.1	188.5	203.4	213.0	189.7	180.8	180.8	175.1

Source: Republic of Croatia - Central Bureau of Statistics, various years Statistical Yearbook

Widespread corruption, barriers to entry into the system, high contribution rates (see Tab. 6) triggered two intertwined phenomena: the informalisation of the economy and massive evasion of contributions, which was concentrated according to sector and work category (Bejaković, 2002:335-338). Waivers on contributions supported shipyard rehabilitation. War veterans, their families, the police and army were all granted exemptions without reductions in entitlements. Certain types of income (honoraria, per diems) did not constitute a taxable base for contributions. Self-employed and farmers registered lower compliance rates also due to failure in adjusting their minimum taxable incomes to nominal wages (Anušić, O'Keefe and Madžarević-Šujster, 2003:19). Another, probably involuntary, source was a messy data and contribution collection system. Multiple agencies with overlapping functions, overstretched audit and the asynchrony between monthly contribution and yearly data collection, leading to protracted delays in monitoring,⁶ lay at

⁶ As Dunja Vidošević became director of HZMO in February 1999, she soon discovered unclaimed credits from as early as 1995. She was the first systematically to analyse the Institute's asset and liability structure. However, her impact was limited, since informatisation of HZMO started only towards the end of her period of office (Matković, interview).

the core of SOEs not contributing or forging data and standing little chance of being persecuted (Bejaković, 2004:69-70).

Moreover, the pension system was extensively used as a buffer for redundant or unemployed workers, the displaced, and to award merit pensions. Its SDR witnessed the spectacular deterioration shown in Tab. 4, its inverse dropping to 1.36 by 2000, one of the lowest in the world and far out of line with the Croatian age structure (World Bank, 1997:78). In fact, had the 1970-1990 Workers' Fund trends⁷ continued, there would have been 2.58 workers per pensioner in 2000. Instead, insureds fell by almost 30% and beneficiaries increased by 55% during the 1990s.

Table 4 Changes in insured, pensioners (in thousands) and SDR

	Old-age pensions ^a	change %	Disability pensions	change %	Total	change %	Insured	change %	Inverse of SDR
1990	321.3	20.8 ^b	166.1	-4.510 ^b	655.8	7.110 ^b	1.968.7	-3.1 ^b	3.00
1991	353.4	10.0	182.6	9.9	719.9	9.8	1.839.3	-6.6	2.56
1992	399.4	13.0	183.0	0.2	774.9	7.7	1.724.8	-6.2	2.23
1993	419.3	5.0	182.1	-0.5	794.8	2.6	1.698.1	-1.5	2.14
1994	440.2	5.0	185.7	2.0	825.1	3.8	1.621.9	-4.5	1.97
1995	443.0	0.6	190.2	2.4	865.8	4.9	1.568.0	-3.3	1.81
1996	457.6	3.3	191.4	0.6	888.8	2.7	1.479.0	-5.7	1.66
1997	477.6	4.4	198.1	3.4	925.5	4.1	1.468.9	-0.7	1.59
1998	495.7	3.8	201.2	1.6	955.3	3.2	1.471.5	0.2	1.54
1999	518.0	4.5	235.4	17.0	1.017.8	6.5	1.406.1	-4.4	1.38
2000	531.5	2.6	237.5	0.9	1.018.5	0.1	1.380.5	-1.8	1.36
2001	539.6	1.5	237.6	0.0	1.032.1	1.3	1.402.2	1.6	1.36
2002	546.6	1.3	235.5	-0.9	1.042.2	1.0	1.422.0	1.4	1.36
2003	554.0	1.3	236.1	0.3	1.054.5	1.2	1.444.0	1.5	1.37
2004	556.7	0.5	238.2	0.9	1.065.7	1.1	1.460.1	1.1	1.37
2005	564.0	1.3	234.8	-1.4	1.080.6	1.4	1.498.9	2.7	1.39

^a The column contains data for both old-age pensions and early retirement.

^b Data for 1989-1990.

Source: HZMO (2006).

This lavishness had multiple origins. On the one hand, the inherited system was overly generous. Low retirement ages – 60 for men and 55 for women with 20 years of pension-qualifying period; 65 and 60 with only 15 years of insurance period or any age with 40

⁷ The Fund's SDR declined from 3.43 in 1970 to 2.83 in 1990.

and 35 years of pension-qualifying period – were coupled with ever lighter penalties for early retirement. In fact, the exceedingly low⁸ and temporary 1.33% decrement per year missing to the minimum pensionable age was lowered in 1989 to 0.5% for those who were laid off as a consequence of bankruptcy or liquidation (HZMO, 2002:65).

Merit pensions, some of which inherited from the former Yugoslav budget, swelled as a consequence of the war.⁹ Lax, decentralised and unsupervised assessments of Homeland War combatant and disability statuses marked a higher than expected inflow of new pensioners – especially during 1995, right after the truce – a major problem alongside baby-boomers (Puljiz, interview).¹⁰ Since a Homeland War combatant average insurance period is 12 years and the average pension is 5,510 kuna, they will more than counterweight those savings deriving from slowed growth in overall merit pensions. By 2005, the beneficiaries of privileged pensions exceeded 16% of total pensioners, and their pensions were some 2.4% GDP, which is more than 20% of overall HZMO spending.

Table 5 Merit pensions 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005	NRR ^a
WWII veterans	76,636	73,466	72,382	70,712	74,668	68,206	63,712	59,244	50.84
Police and judiciary	12,791	12,816	13,679	14,257	13,980	16,567	16,633	16,560	74.82
Members of government	144	126	125	100	408	524	486	444	48.51
Croatian Academy of Sciences and Arts	87	79	81	82	108	152	163	167	154.93
WWII Home Guard veterans	35,614	34,090	33,932	32,788	28,705	30,102	28,584	26,967	42.9
Members of the former Yugoslav National Army	16,667	16,217	15,784	15,467	14,947	14,467	14,057	13,542	58.34
Former political prisoners	3,972	5,668	5,976	5,893	5,772	5,765	5,807	5,778	76.74
Members of parliament	119	112	119	121	269	296	336	354	198.26
Croatian Army	2,237	2,364	2,769	3,783	6,676	7,919	6,814	11,265	65.15
Veterans from the Croatian Homeland War	22,612	26,110	28,551	29,300	29,425	32,249	36,559	39,821	123.18
Total	170,879	171,048	173,398	172,503	174,958	176,247	173,151	174,142	

^a *Average pension per category on average wage in 2005. Regular NRR amounted to 41.8 in 2005. Differences between privileged and civilian disability are marked as well.*

Source: HZMO.

⁸ According to Anušić, O'Keefe and Madžarević-Šujster (2003:27), international experience indicates that suitable annual and permanent decrements should be 5% or more.

⁹ For a complete account of different privileges, see Gulin (2002).

¹⁰ The abuses became so blatant that the RFMO soon imposed a six-month waiting period and heightened central supervision over regional offices. Results were, however, meagre (World Bank, 1997:79).

A special scheme (OG 25/90), allowing for very generous buyouts of missing insurance periods of up to five years, was established in June 1990. Employers used it as a substitute to labour market adjustments until 1995, when it was discontinued by the new Labour Code (OG 38/95). Some 100 thousand workers aged 51 on average, representing 20-25% of jobs lost during transition, purchased roughly 175,000 years of service (Andrijašević, Kovačević and Sabolović, 1997:241; World Bank, 1997:78).

Another 'populist' directive granted longer insurance periods (up to 18 months) per insured year to a series of professions, usually involving unhealthy and risky jobs, or due to personal unfavourable psychophysical conditions. Under socialist Yugoslavia, work categories were abolished and the list currently in use was drawn in 1999 (Zakon o stažu osiguranja s povećanim trajanjem, NN 71/99). Other beneficiaries (police officers, professional soldiers, fire-fighters and bomb disposal personnel) were regulated by special law.

For completeness, it is worth mentioning Art. 243 of the Labour Code, which granted early retirement to all disabled persons who had residual working capabilities, but who were laid off due to the impossibility of reemployment. This practice lasted from January 1996 until the Pension Insurance Act entered into force in January 1999.

2.2.2 Financing the collapse

In order to finance the system's generosity *cum* deterioration, three strategies were used. Two tried to refinance the system: contribution rates were progressively increased (see Tab. 6) and some 15% of total privatisation assets were assigned to RFMO in 1992, unrealistically hoping that they would generate revenues. The third introduced radical cut-backs. At the height of economic crisis, PM Nikica Valentić launched his (in)famous stabilisation programme, whose effects are still felt today.

Table 6 Changes in contribution rates^a

Period	1990 ^b	1991	23/4/1991 31/12/1993	1994	1995 1997	1/2/1998 31/5/2000	1/6/2000 31/12/2002	2003 onwards
Employees	16.70	9.50	11.00	13.50	12.75	10.75	10.75 ^c	20.00 ^c
Employees	7.40	9.00	11.00	13.50	12.75	10.75	8.75	0.00
Total	24.10	18.50	22.00	27.00	25.50	21.50	19.50	20.00

^a These are not the rates effectively financing pensions. In 1995-97, some 5.5% were diverted by RFMO to the Croatian Health Insurance Institute (HZZO) to finance health care of retired persons.

^b These still refer to personal and work organisations' income. Payroll contributions were introduced in 1991.

^c Total employee contributions. If participation in the 2nd pillar is chosen, then 1st pillar employee contributions are respectively 5.75 and 15.00. The remaining 5.00 goes to the funded pillar.

Source: HZMO (2002: 93) and Pravilnik o doprinosima za obvezna osiguranja, NN, 01/05

2.2.2.1 RFMO and ownership transformation

According to the Socially-owned Enterprises Transformation Act (NN 19/91), all but 10 major Croatian enterprises were given one year to transform into joint-stock companies

and eventually prepare a privatisation plan. Manager and employee buyouts were given top priority, while unsold shares as well as stakes in limited liability companies were offered to some institutional investors. The Workers' and Farmers' Funds were allotted 60 and 30% respectively, while the Self-employed Fund was assigned 10% of the pensioners' portfolio. In order to trade with these assets, the Funds established in April 1992 the joint-stock company Croatian Pension Insurance (HMO)¹¹. By 1998, the cumulative nominal value of transferred assets amounted to DEM 4.2B (HZMO, 2002:81-82).

The initial hopes were for these assets to produce enough returns to resume full indexation. However, the World Bank (1997:82-83) maintained that this expectation was unrealistic at best. Under optimal conditions, the returns generated by the Croatian Pension Insurance returns should have covered some 5% of annual spending. Instead, the actual figure stood at 2.1% in 1995, thereby implying that the assigned assets were seriously overvalued, the restructuring of underlying companies was delayed and corporate governance neglected.

On the whole, the importance of privatisation assets for Croatian pension reforms remained very marginal, however, the scandals surrounding the management of the Croatian Pension Insurance Institute considerably undermined pensioners' confidence in the institution and consolidated the view, often reiterated by pensioner associations, that the HDZ had stripped pensioners of their belongings through 'scam privatisation' (Bejaković, interview).¹²

2.2.2.2 Beyond stabilisation

The violent conflict with neighbouring Serbia that erupted soon after the achievement of independence reduced the Croatian economy to a shambles. International financial institutions did not lend the country support, thus foreign capital inflows were frozen due to high risk. The damage included the tourist industry's ceasing to operate. As the new PM Nikica Valentić took office in April 1993, his government's paramount task was to build an anti-inflationary reputation in order to be able to fend off interest groups that might oppose a stabilisation programme.

The programme was kept secret until 3 October 1993, the day of the announcement, to prevent foreign exchange speculation. It entailed three stages: a short-run inflation reduction, through a fiscal and monetary squeeze, followed by structural reforms to maintain a low inflationary equilibrium (pension reform was part of the third, long-term stage). The first stage functioned magnificently: by November inflation fell to 1.4% and producer prices deflated by 4.6% (Valentić, 1997). However, its social impact was hard.

¹¹ The three Funds established in 1997 a proper investment fund, the Croatian Pension Investment Company (HMID), which never evolved into a major institution.

¹² Some of the biggest scandals regarding privatisation to HDZ cronies revolved around HMO. HZMO director Dunja Vidošević started unveiling part of the carnage that happened under her predecessors Stjepan Brčić (1990-96), Silvio Mićin (1996-97) and Damir Zorić (1997-99). The most glaring case concerned the highly popular newspaper *Večernji list*, while the last *boutade* was attempted a few days before the 2000 elections, on 29 December 1999, when a – later blocked – transfer of Croatia osiguranje shares, the biggest Croatian insurance company, from the Croatian Privatisation Fund to HMO was ordered by some unidentified HDZ official. The *raison d'être* was the less demanding alienation procedure applied by HMO (Petrović, 2000).

Ad hoc indexation started with a strict limitation of available resources devoted to pensions and wages. In order to curb hyperinflation, the amounts allocated for pension benefits were to increase by 4% between October and November 1993 and by another 4% in December. These percentages had no resemblance whatsoever to price, wage or GDP growth. Subsequent decrees, lasting until December 1996, consolidated this trend.¹³ As crude as it may sound, spurious indexation was common practice in transition economies, and, according to Cashu (2003:4), the most effective retrenchment measure. Notwithstanding this, the Valentić government went much further.

Approximately 160,000 beneficiaries entitled to merit pensions, who throughout their lifetime did not or only partially contributed towards the RFMO, were not refinanced by the budget. In addition, at least until mid-1996, the government tolerated contribution evasion, which led to major delays during ordinary payment processes and further diminished the available resources (Županov, 1996:286-287). RFMO revenues experienced a 15-20% shortfall, and therefore the RFMO adopted an internal regulation to determine the calculation and growth of benefits. Among others, it started calculating the pension base from net, instead of gross wages in 1994 (Matković, 2000a).¹⁴

The end result of these measures was a drastic drop in replacement rates, see Tab. 7.

Table 7 Average net replacement rates^a

Year	1990	1991	1992	1993	1994	1995	1996	1997
NRR ^b	75.29	62.80	63.19	61.76	52.54	45.88	45.85	47.01
Year	1998	1999	2000	2001	2002	2003	2004	2005
NRR ^b	46.32	38.37	37.62	41.40	40.73	40.00	42.13	41.8

^a The net replacement rate for old-age pensions only was much higher, its relative fall more pronounced.

^b Net average pension on net average wage.

Source: HZMO (2006).

The reaction by pensioner associations was almost immediate. On 27 October 1993 they challenged the 1993 decrees before the Constitutional Court. However, the latter started examining the pensioner associations' complaints only in July 1996, three months after the HSU was founded on 29 April 1996 specifically for this purpose.¹⁵

In order to mitigate growing unease, the same Valentić government authorised in May 1995 a symbolic 50 kuna individual supplement (Uredba o utvrđivanju mjesečnog dodatka uz mirovinu, NN 33/95), which, however, only marginally improved the situation.

¹³ The Pension and Disability Insurance Act was never actually changed, since decrees granted here more flexibility in case social protests or unrest broke out.

¹⁴ In reality, what happened was a proper forging of data on wages in order to keep valorisation at the level sufficient to pay out pensions (Anušić, interview), meaning that the old benefit calculation formula with generous accrual rates (approximately 2.2 for men and 2.5 for women per year of service) was discontinued.

¹⁵ For an overview, see <http://www.hsu.hr/povijest.php> [cited 26 January 2007].

"It is widely presumed that any pronounced challenge to the basic structure of the system is equivalent to political suicide", is a rather abused quote from Buchanan (1983:340), which, however, never proved as wrong as in the Croatian case. Instead of being bitterly punished, the HDZ triumphed at the October 1995 elections, gathering 45% of the vote and 59% of *Sabor* seats. A tentative answer will be provided.

2.2.2.3 Disarray, demobilisation, disinformation and delay

These four factors lay at the heart of pensioners' failure to react, contrasting with their potential for single-issue voting, which was perceived as a major political threat in the rest of CEE (Guardiancich, 2004:58). Resembling Orwell's 1984 dramatic scenario, Tuđman's Croatia was incapable of acting collectively and closely resembled Claus Offe's associational wasteland.

Pensioner associations were in total disorder. In fact, the only worthwhile collective action was the appeal to the Constitutional Court, originally supported by the House of Croatian Pensioners (MUH), the Union of Croatian Pensioners (SHU), the Socialist Party (SS). Failing to be represented at parliamentary or government level in an increasingly authoritarian country boded disaster. However, inefficient leadership is probably to blame most, since SHU and MUH were too opportunistic, while the association 'Croatian Pensioner' (DHU) lacked a sufficient number of members, founded as it was by intellectuals and professionals.

Moreover, Croatian civil society was sunk in apathy. The media, trade unions, minor political parties: none of these actors, which in Western but also some transition countries lend support to the retired, pointed to or capitalised on the fact that pensioners were being sacrificed to finance the defence of the country, as President Stipe Mesić stated more than ten years later (Ivićev Balen and Hina, 2003). However, this lack of participation may be ascribed to the very nature of the HDZ. This political party, mass political movement and national liberation front symbiosis developed a system of 'limited pluralism', where antagonist political parties existed but had their electoral rights constrained and the mass media were 'free', but obstructed by purges, control of radio frequencies, eavesdropping and manipulation of the press distribution agency Tisak (Grubiša, 2002:36-39).

This prepared the stage for HDZ's audacious bet. As hyperinflation in 1993 touched 1617.5%, radical stabilisation was unavoidable. No government unsure of future electoral support would have distributed the economic burden of reforms so unevenly. In fact, limiting the growth of wages would have had a much more balanced effects on both workers and pensioners. Instead, at first both pensions and wages were blocked and subsequently only wages were allowed to grow freely. The divergence between the two was therefore delayed and the impact on net replacement rates was fully felt only by 1995 (Mintas Hodak, interview). At this point, HDZ boldly justified its manoeuvrings through propaganda based on ethno-nationalism and asymmetric information. The pensioners' strain was either denied, attributed to former Yugoslav heretic economics or lauded as a patriotic act.

Županov (1996:289) draws from the survey 'Izbori 1995' the following: 54.5% of pensioners deemed HDZ to be the party representing them most and 50.7% were going to vote for it, while the percentages for the whole sample were, respectively, 45.7% and

34.1%. Thus pensioners still embodied HDZ's main constituency, undeterred by the party's social policy usurpations.¹⁶ Nonetheless, it has to be stressed that HDZ prepared the 1995 election meticulously.

Military success and the opposition's inherent weakness pushed the economic woes of the country to the background. In 1995, the Croatian Army led the successful campaign *Oluja* (Storm), thereby recapturing Slavonia and Krajina, and the war in Bosnia ended with the Dayton peace agreement. Tuđman called for elections a year early to capitalise on his sudden surge in popularity, and the electoral system was carefully remodelled. Out of 127 *Sabor* seats, 80 were purely proportional, 28 were attributed to *županije*, enlarged counties, 12 were reserved for émigrés and 7 for national minorities, among which there were only 3 for Serbs (Bartlett, 2003:46-49).

To sum up, the HDZ was at its peak in 1995, supported as it was by rekindled nationalist fervour. Probably, even without any tricks, an electoral defeat was simply out of the question. The new PM Zlatko Mateša took office on 7 November 1995. Eventually he became the first to serve a full term.

2.3 Pension reforms, at last!

Post-1991 Croatia was characterised by many failed attempts at kick-starting pension reforms, which were otherwise perceived as unavoidable. The inherited pension system was duly incorporated into Croatian legislation in October 1991. The RFMO was on its own accord developing a parametric reform of the PAYG system – whereby contribution rates, benefit formulae, and other parameters are changed without any larger systemic reforms, as for example the introduction of funding etc. – a carbon copy of the 'German point system', which was well suited for the continental-corporatist aspirations of Croatia, whose prominent scholars were trained within the Bismarckian tradition.

Bodiroga-Vukobrat (1994:334) mentions a full pension reform draft of April 1994, envisaging parametric reforms of old-age and new definitions in disability pensions. Notwithstanding, the dozen or so Pension Insurance Act alternatives, presented in 1992-94 were repeatedly dismissed. However, most concepts were retained and built upon, to be finally transposed into the 1998 Pension Insurance Act.

The five-year suspension was a consequence of various factors. Government priorities (stabilisation relegated all structural reforms to the background) and external circumstances (the raging Homeland War) characterised the period up to 1995. Once a multi-pillar strategy was chosen in late 1995, fiscal concerns (transition costs could have been financed only by a more solid budgetary base, later granted by the introduction of VAT) and lack of expertise, remedied by World Bank's involvement, ensured that concrete proposals landed on the table only by 1997.

Thus, the second and third stages of PM Valentić's stabilisation were discontinued as hyperinflation was eliminated in only one month. The falling net replacement rate consequent to *ad hoc* indexation should have been justified by pushing a multipillar reform as early as 1994, but the escalation of the conflict demanded large budget transfers.

¹⁶ The support, however, abated with respect to 1992 (62%), but this is attributable to a general trend, rather than to specific socio-economic factors.

Müller (2003:96-97) identifies the conceptual turning point in the November 1995 international conference in Opatija, organised by the Croatian government, the East-West Institute and the World Bank. Following the 'euphoric' parliamentary elections (see paragraphs above), this was the inaugural appearance of the newly appointed PM Zlatko Mateša, who endorsed a multi-pillar reform. The focal point for economic reforms lay within the Ministry of Finance, headed by their fervent advocate, Borislav Škegro. However, Croatian policymakers were chiefly inspired by their Chilean émigrés¹⁷ and by the World Bank's global campaign for pension privatisation.

In contrast to other CEE countries, especially Slovenia, a counterbalancing role of the EU was missing in Croatia. In fact, due to the political conditionality attached to PHARE (later CARDS for South Eastern Europe), Croatia was included only after the end of hostilities in Kosovo in 1999. The WB had by that time been already active for five years, starting with an US\$ 128 million Emergency Reconstruction Loan in June 1994 for damaged infrastructure reparation.

The initially programmed reform schedule was very optimistic. Legislation in 1996 and two-stepped implementation in 1997: new public pillar parameters first, to restrict eligibility and create a solid base for second pillar contributions, starting in mid-1997. Pension system forecasting and legislative drafts were prepared using the Japanese grant. A WB public sector adjustment loan (PSAL) was planned, but eventually not realised. The semi-annual cost for a second pillar contribution rate of 10% was included into the 1997 draft budget; however, more pressing fiscal priorities entailed an indefinite suspension of reforms (Anušić, O'Keefe and Madžarević-Šujster, 2003:23-24). The June 1997 presidential election, where Tuđman triumphed again,¹⁸ demanded the disbursement of scarce budgetary resources, while numerous postponements to the introduction of VAT (OG 47/95) prevented Finance Minister Škegro from having a secure revenue base at disposal to cover transition costs (Mintas Hodak, interview).

As a way to deal with the prolonged crisis, the Act on the indexation of pensions (OG 20/97) was passed in early 1997, thereby putting an end to the customary 'rule by decree'. The Act amended the unresolved situation by introducing: a) a partial compensation for below net wage growth indexation between February 1995 and December 1996; b) indexation calculated twice a year on the 6-month average inflation from January 1997 onwards. Valorisation based on wage growth resumed at the margin, following the old Pension and Disability Insurance Act of 1983, and transfers for merit pensions were restored.

However, the Act improved neither the fiscal position of RFMO, definitely compromised by increasing SDR, nor the pensioners' deteriorating situation, since it was a mere pretence at debt repayment and was actually insufficient to mitigate the effects of

¹⁷ Among these, stood out former Chilean MoF Hernán Büchi – at the time of MoL Piñera, who was himself present at the Opatija conference – who became in the early 1990s advisor to the Croatian President, and Androniko Lukšić, one of the wealthiest Chileans and a major investor in Croatia (Anušić, interview).

¹⁸ At the time, the first cracks in HDZ's hegemony became evident. President Tuđman abused his powers during the Zagreb crisis, by not confirming the appointment of the elected opposition mayor. The crisis lasted from October 1995 until April 1997. Furthermore, the attempt at privatising Radio 101, a staunch opposer of the HDZ regime, to a conniving tycoon brought in November 1996 100 thousand protesters onto Ban Jelačić Square in the centre of Zagreb.

price indexation. Thus reforms became simply inescapable, and soon after the presidential election, in September 1997, the first pillar law (the Pension Insurance Act) was submitted to the *Sabor*.

Moreover, the 1997 Act also discontinued all preceding indexation-limiting decrees. Consequently, notwithstanding sporadic allegations of politicisation at the Constitutional Court level, the latter could not but interrupt the procedure initiated by pensioner associations in 1993. The Court's explanation was that the two norms already ceased to have effect (OG 48/97), and not, as the RFMO later tried to insinuate, that indexation matters prior to January 1995 were resolved. This resolution turned the press and pensioners against the Court and it effectively pulled the trigger for the most perverse development in Croatian pension reform history (see the following paragraphs).

2.3.1 Streamlining reforms through the Plenipotentiary

After the first reading of the Pension Insurance Act, reforms entered full swing. The public pillar law was designed as a hands-tying arrangement for the introduction of the funded pillar. In its final version, Art.1-2 of the Pension Insurance Act set the three-pillar WB design in stone, and prescribed a (problematic) contribution rate "not lower than 5%" for all insured younger than 40.

In December 1997, the World Bank published *Croatia Beyond Stabilization* (World Bank, 1997), where it addressed design and fiscal issues of transition to a multipillar system. Among others, internal financing was given top priority. Suggested public pillar squeezes (price indexation, formulae based on lifetime earnings, actuarially fair maluses, increased retirement age) would generate savings amounting to 2% GDP *per annum* by 2010.¹⁹

The report then focused on the 2nd pillar and three options were put on the table: a) a Chilean style reform which would however create a huge double payment problem; b) a gradualist approach, financed by internal savings, but prone to capture; c) a partial, but irreversible switch to a funded system, whose transitional cost would have been bearable. With it the World Bank gave Croatian politicians the right of choice, but it also made clear that the third option was preferred. The report envisaged a 40 cut-off age, and the creation of a semi-flat public pillar granting a 30% net replacement rate and a funded one providing another 35%. Half of the current employer and employee contribution (circa 10% of gross wages) was initially suggested, amounting, due to the relatively low cut-off age, to some 4-5% of total payroll in Croatia, or 2% of GDP flowing into the funded pillar *per annum*.

With respect to financing, *Beyond Stabilization* advised against mandatory pension funds (MPF) holding equity in privatised companies, especially to avoid governance and ownership distortions. Given the tormented history of privatisation under HDZ and polemics around the issue (Zdunić, 1996), a 'sell-off approach' of HMO assets as opposed to a

¹⁹ The first Pension Insurance Act draft submitted to the *Sabor* envisaged an equalised minimum pensionable age of 65. Notwithstanding the huge differences in life expectancy at retirement between men and women (8 years) and current European practice, the parliamentary debate led to the replacement of the proposal with the current solution, 65 for men and 60 for women (Anušić, O'Keefe, and Madžarević-Šujster, 2003:26). Given the conservative nature of HDZ, this development was not surprising.

‘direct conversion approach’ was preferred at least for three reasons: it increases mandatory pension funds’ credibility, as they have to build their portfolio from day one; it channels additional liquidity into capital markets, thereby speeding their development; it unfreezes a congealed market, as most Croatian equity was at the time held by the Privatisation Fund, HMO, banks and the State.

Since the debate revolving around the three laws would not have proven easy, the government established a Plenipotentiary for pension reform in February 1998 (OG 27/98). The newly introduced VAT produced a strong impact on 1998 revenues, and therefore reforms started to be pursued with renewed determination. The Plenipotentiary was independent, a firm condition imposed by Zoran Anušić, a former advisor to PM Mateša, who was seconded from the World Bank and who helped maintain informal Bank-government relations at a time when these were corrupted (World Bank, 2004:iii-iv). However, it definitely did not depoliticise the issue. The Plenipotentiary’s coordinator was Deputy PM Ljerka Mintas Hodak, so neither the Ministry of Labour nor the Ministry of Finance, as Müller (2003: 97-98) notes, were involved. Nonetheless, its Board was basically the PM’s narrow cabinet. Apart from Mintas Hodak, MoF Borislav Škegro, Minister of Labour and Social Protection (MoL) Joso Škara and Minister for Privatisation Milan Kovač sat on the board, as well as Željko Potočnjak²⁰ and Damir Ostović, aide of the Minister for privatisation, respectively heads of the legal and economic working groups.

The two working groups had their tasks divided. The economic group had to prepare draft legislation on the second and third pillars and the legal group all the accompanying legislation. Together they were also in charge of collaborating in the final phases of the Pension Insurance Act, as well as of preparing the public information campaign and ultimately of implementation. The two groups employed 18 people as permanent staff and were assigned a budget to hire external consultants.

The adoption of legislation proceeded rather swiftly, after the creation of the Plenipotentiary, so that the government was accused of resorting to ‘*mandatism*’ (Müller, 2003: 102), which is possibly a superficial interpretation of events. The lack of veto points perhaps better depicts the situation.

Interest groups – trade unions, academia, the financial sector – that played key roles in other countries’ reforms remained silent. Opposition was chiefly voiced by pensioner associations that were clearly concerned with marginal issues in a reform producing its full effects in 25 years’ time. Consequently, coalition-building played little role in the subsequent postponements of reforms.

Minor delays in legislation adoption were generated by external events and careful sequencing (the 1998 Constitutional Court’s decision, the need for a finalised Annuities Law), while major setbacks in implementation were chiefly connected to the 1998-99 banking crisis and subsequent recession as well as to the HDZ’s electoral defeat following Tuđman’s death, and political reappointments after the SDP and HSLs took power.

Some of these factors will be analysed in the following paragraphs, starting with the Constitutional Court’s populist pronouncement.

²⁰ Professor Potočnjak was a veteran of legislation entailing great conflict potential, as he had been involved in the drafting of the new Labour Code.

2.3.2 Pensioners' revenge and the Constitutional Court decision of 12 May 1998

The 1997 Court resolution (see earlier paragraphs) only rekindled pensioner associations' efforts. SHU, MUH, together with HSU challenged the constitutionality of the 1997 Act on the indexation of pensions on equity and procedural grounds. A year later, the Court upheld the annulment of the Act almost in its entirety.²¹

Four and half years after PM Nikica Valentić limited overall resources to finance wages and pensions to stabilise the Croatian economy (OG 91/94, 93/93), the Croatian Constitutional Court annulled all but two articles of the Act on the indexation of pensions on the grounds that a series of temporary measures, adopted due to an unfavourable financial state of affairs in Croatia, had been rendered permanent, thereby causing major losses to current pensions and precluding compensation for prior damage.

As Anušić, O'Keefe and Madžarević-Šujster (2003:33-34) and Bejaković (2006) maintain, the Court based its decisions on two sets of claims. RFMO's indexation of pensions from November 1993 until December 1998 was discontinuous due to intentional *ad hoc* indexation and inadequate valorisation stemming from the transfer of insufficient resources to the RFMO (OG 69/98).

2.3.2.1 The court for the people

Two questions arise from this Constitutional Court decision, which had the effect of an earthquake on Croatian politics, the shock waves of it still being felt today.

First, on what grounds did the Court establish this right for pensioners? Two interpretations exist. One is based on equity premises: the supplements granted by the government inadequately covered the Republican Fund of Pension Insurance deficits deriving from discontinued budget transfers. Some compensation was due. Additionally, the 1997 Act violated the Constitution by negating rightful reparation for failed wage growth indexation between October 1993 and December 1996. The other interpretation is purely procedural (Anušić, interview) and does not alter the essence that a right for indemnification was thereby established.

This leads directly to the second, more important question: should the Constitutional Court have acted in the first place? There is basic agreement between legal and economic experts that the answer is no. At first, the Court followed a wait-and-see strategy through administrative silence until July 1996, probably considering the case a very risky one, given the economic instability of the country. Its President, Jadranko Crnić, wanted to present the Court as an independent body, thus some decisions were passed against the interests of the government. However, the 1997 Resolution rendered the Court very unpopular overnight, since both the media and pensioner associations pointed the finger and accused it of politically supporting the government (Mintas Hodak, interview). In order to correct this 'popular' delegitimation, the Court probably chose the wrong subject, the wrong procedure and the wrong constituency.²²

²¹ For many valuable comments on the Constitutional Court's role in Croatian pension reforms I have to thank Professor Željko Potočnjak, a judge of the Constitutional Court of Croatia.

²² For this illuminating discussion I have to thank Viktor Gotovac from the Faculty of Law of the University of Zagreb.

The subject was wrong, because by definition any (unnecessary) redistribution from the active to the inactive population under severe financial constraints cannot even be a potential Pareto improvement.²³ In addition, much of the money was disbursed from 2007 onwards, 14 years after the Valentić decrees, meaning that most of these resources will be inherited by the same people that finance them.

The procedure was wrong, because the decision points to a strict interpretation of the law, rather than to a creative way of killing two birds with one stone. The Court was at the time filled with practitioners rather than with theoreticians and maybe the necessary inventiveness was lacking. In fact, an elegant solution would have been to emulate the *Marbury v. Madison* case, the first one when the US Supreme Court acted as a judicial review court. Establishing that the incriminated decrees violated pensioners' vested legal rights, and that a legal remedy existed would have maintained that Croatia is a state based on the rule of law. Stating that the Court did not, however, have the jurisdiction or power to enforce that right, would not only have avoided the ensuing interminable complications, but also it would have put the Constitutional Court above the rest of the judiciary and relegated its action only to grandest rights and hardest cases.

Thus, it follows that the Court chose the wrong constituency to regain its legitimacy. By acting as a 'popular' court it impersonated an additional Ombudsman in opposition to the government. Whether this was due to institutional or personal disagreement with the government is ultimately unimportant,²⁴ since the 1998 decision proved to be a Pyrrhic victory if not a real defeat. The right to compensation did not solve pensioners' woes and legitimization by the people downgraded the Constitutional Court to a minor role within the judiciary, since appeals to it are currently and increasingly abused, even regarding rather trivial issues.

2.3.2.2 Immediate effects

This 'victory' did not produce any tangible results for pensioners. The government led by PM Zlatko Mateša continued to dismiss the deriving obligations, thereby only confirming some disregard for the rule of law during the twilight of Tuđman's HDZ. An internal dispute erupted. Whereas MoF Škegro was adamantly opposed to any concessions, lawyers, such as Deputy PM Ljerka Mintas Hodak, claimed that a judicial decision cannot be simply ignored. Finally, under multiple pressures, the MoF gave in and PM Mateša acknowledged that Croatian governments during 1990-97 had not fulfilled their budgetary commitments towards the three HZMO predecessors.

During the same parliamentary session when the Pension Insurance Act was legislated, the *Sabor* passed the "small" Pension Law' (*Zakon o mirovinskom osiguranju*,

²³ In fact, pensioners usually display a higher propensity to consume than wage earners, therefore such redistribution only diminishes private or enterprise savings in a country starving for more investment (cf. World Bank, 1997: 78). In addition, the HZMO stated in various occasions that a precise calculation of the pensioners' debt would have taken some 7-8 months to perform. To establish these rights, the Court instead employed one single actuary (Ivan Tkalac) and was therefore simply unaware of the full extent of this debt.

²⁴ A political disagreement is probably excludable, since few judges were at the time affiliated. However, HDZ's governing style was resented. The government acted as it were above the law and it often interfered with the judiciary, both of which probably triggered the Court's reaction.

NN 102/98), which allocated HRK 7 billion for failed transfers for merit pensions and contribution deficits and an additional HRK 0.5 billion to cover state obligations for insolvent enterprises. The overall sum roughly matched pensioner associations' calculations and was to be disbursed during the period 1998-2002 in 9 instalments to beneficiaries who got their rights curtailed between September 1993 and June 1998, costing circa 1% of GDP *per annum*.

The final result of this reparatory act was that a permanent damage to pensioners was dealt with sloppily. The later HZMO was delegated the task to define ways to distribute the promised money and it proposed a rather logical proportional distribution, but MPs changed it during debate. Djuro Njavro (HDZ) put forward a more redistributive formula²⁵ of 100 kuna + 6% (Njavro's supplement), which, as will be shown later, was bound to create a major hassle as the date of its expiry, December 2002, neared.

The supposed direct impact was, however, mixed. On one hand this decision provided renewed impetus to pass the public pillar reform, but as the Croatian public and trade unions got distracted, on the other hand, it destabilised fiscal calculations of transition costs. The fall in net replacement rates was perceived as a window of opportunity for partial privatisation, and its reversal would have jeopardised the efforts already made (Müller, 2003:98).

2.3.3 Right sequencing

Despite various postponements, Croatian reforms were both technically and chronologically impeccable. The Pension Insurance Act was adopted in July 1998, it entered into force in January 1999 and it opened the door for second pillar legislation. Since the Polish experience (the failed adoption of an Annuities Law) was looming large, as the Funds Act entered parliamentary procedure, MPs requested a draft law regulating annuities and pension insurance companies before passing it.

This determined a delay between the first and second readings of the Funds Act and triggered the first postponement of contribution diversion, from January to July 2000.

2.3.4 Interest groups' involvement

Ljerka Mintas Hodak (interview) decries the fact that, despite the public awareness campaign, those most affected by reforms, i.e. younger generations, were only marginally involved in the discussion.²⁵ The four main groups that could have been voicing their suggestions were trade unions, pensioner associations, the financial service industry and academics.

2.3.4.1 Trade unions and pensioner associations

The first two groups were characterised by extreme fragmentation and disarray. Trade unions were divided into hundreds of units and five registered confederations. The greatest, the Union of Autonomous Trade Unions of Croatia (SSSH), counted only 211 thousand members in 2004. Despite some incoherent opposition against partial privatisation,

²⁵ Some of the cited authors, Zoran Anušić and Predrag Bejaković, assert that the Croatian national team's 3rd place at the 1998 FIFA World Cup is partly to blame for lack of public attention.

not backed by any autonomous proposal, they did not influence the reform process. This anomie resulted from interrelated problems: lack of knowledge²⁶, failure to recognise the social and fiscal implications of pension reforms for workers, and insufficient political resolve for joint action (Milidrag-Šmid, interview).

The absence of inventiveness is testified by a rigid understanding of the pension issue as a generational competition over scarce resources, and probably even by lack of opportunism. On the latter point, the only trade union that planned to establish a funded pension scheme (the now incorporated *HA jedan*) was the Trade Union of Public Employees, thereby converting falling short-run membership advantages into longer-term financial returns. The others basically overslept the Pension Insurance Act and repeatedly showed how changes in the Labour Code were their main, if not only concern (Cimeša, 2003). Trade unions were criticised for their lack of commitment by the government, because they did not engage in a structured debate with pensioner associations (Mintas Hodak, interview), as well as by the retired themselves and academics for not defending future workers' rights (Kalajdžisalihović, 2003b; Matković, 2005b).

On the other hand, two structural anomalies have to be pointed out. First, the informational asymmetry was exploited in government favour, since social partnership was possibly just fictive. Trade unions claim that they were presented with close to finished draft laws, which did not require their approval. As a matter of fact, the predecessor of the tripartite Economic and Social Council was prior to 2000 inconsistently managed and displayed uneven results.²⁷ It had little credibility with the public and even social partners, a talk-shop that accomplished nothing. Thus executive decision-making was at the time still perceived as the main driver of reforms, leaving very little legitimacy for social dialogue (Lowther and Sever, 2006). Second, it is hard to expect the government to take seriously a trade union, not to say a fragmented bunch, when the unemployment rate oscillated between 15-20% (ILO definition).

In contrast, the Plenipotentiary's position is on the latter two points diametrically opposed to that of trade unions (Anušić, personal communication), and probably the truth lies somewhere in between. In fact, Snježana Plevko (member of the economic working group), Damir Ostović and Zoran Anušić held several presentations for each trade union and employers' association separately and jointly. Two additional pension reform sessions of the Economic and Social Council were requested by the Government with the objective of getting a green light for the reform from all social partners before sending the Pension Insurance Act to the *Sabor*. All participants gave their full support: Đuro Popijać for the Croatian Employers' Association, and Davor Jurić, Boris Kunst, Dragutin Lesar (SSSH), Vilim Ribić, Krešimir Sever for the trade union confederations.

Despite the different interpretations, the results were univocal. While trade unions should have had an all-encompassing interest in reforms, their inactivity was substituted

²⁶ Pension privatisation was at the time still a novelty, and poorly financed groups were unable to secure the necessary expertise on time.

²⁷ An attempt to change things was only started after 2000, when at the request of the SDP, USAID commenced the Tripartite Dialogue Project.

for by the public focussing on particular issues. Puljiz (1999:14-16) defines two, both related to the public pillar. Setting the retirement age at 65 for both genders was intensely opposed by female MPs and women's associations, while price indexation was the major concern for pensioner associations. A rather efficient neutralisation of both groups was achieved simply by agreeing to their demands. Therefore, the minimum pensionable age for women was lowered to 60 and price indexation was replaced by the 'Croatian formula', an average of wage and price growth calculated twice a year.²⁸

However, nothing close to an alternative to the three-pillar structure was proposed, and the funded pillars were insufficiently publicly debated.

2.3.4.2 Academics

Only a small group of scholars, including both legal experts and economists, criticised reforms. Among the former, Puljiz (1999:16) was particularly caustic: "There have been quite a few competent estimates that the second pensions reform has not been sufficiently well-prepared, that it is being conducted in unfavourable economic and social conditions and that, for these reasons, it will not achieve the objectives on the basis of which it has been inspired". Some of these criticisms were shared by economists. Both Bakić (1998), a mathematician, and Škember (1998), from HZMO, claimed that the one major hurdle for correct implementation was the underdeveloped, unstable financial and banking systems. Notwithstanding this, they were both 'co-opted' into the Plenipotentiary and drafted reforms. The bottom-line is Milidrag-Šmid's claim that in Croatia there was no social security expert *à la* Tine Stanovnik, coherently supporting an antagonist position to that of the World Bank.

2.3.4.3 Financial service industry

As for the lobbying of the financial industry before the 1999 reforms, Anušić rightly claims that the Croatian legislator was swift and unconditioned, which is understandable considering that, prior to 2000, asset management barely existed in Croatia. The four major banks entered the business alongside minor players: Zagrebačka Banka, Privredna banka Zagreb, Erste & Steiermärkische Bank, and Raiffeisen Bank Austria. Consequently, their involvement in the fine-tuning of the system started only once the pension fund industry was firmly established.

2.4 The Pension Insurance Act

The Pension Insurance Act was adopted in July 1998 and implemented in 1999. Participation in the multipillar system was rendered mandatory for all the insured under 40 and optional for those aged between 40 and 50. A major departure from the original draft was the substitution of a 10% contribution rate to the funded pillar by the formula "not lower than 5%", which dissatisfied everyone but Finance Minister Škegro.

²⁸ In the 'Swiss formula', valorisation follows net wage growth and only indexation is a wage-price mix. Less favourable valorisation followed to the 'debate on three retired school teachers'. These would in a 'Swiss formula' world end up with different pensions. In fact, the asymmetry between indexation and valorisation grants higher benefits to the one retiring earlier (Anušić, O'Keefe and Madžarević-Šujster, 2003:28).

The problem was of course double payment. However, the criticisms were assorted. Anušić proposed a gradual increase, similar to Hungary, and claimed that excessive deficits would have been dealt with later. The government was even aware that most of the contributions would have come back in the form of bonds. Notwithstanding, the MoF was irremovable and the unfortunate formula was retained. Not surprisingly, *nomen est omen*, the rate stayed at 5% sharp (Anušić Mintas Hodak, interview).

Apart from this one, few other political adjustments were needed. The Pension Insurance Act represents a radical parametric retrenchment for both old-age and disability pensions. The pension formula underwent the most radical change. All participants have at least part of their pensions calculated according to a 'German point formula'. Second pillar participants' benefits are determined by a two-tier formula, the 'basic pension', consisting of a point-based part and a flat, service-related component.

Table 8 Reforms in the public pillar

	Men	Women
Retirement age and min pension qualifying period	The min retirement age increases from 1999 on by 6 months per year, and the pension qualifying period decreases by 6 months per year. By 2008 the reform will be definitely phased in. 65 with 15 years of pension qualifying period	60 with 15 years of pension qualifying period
Early retirement	The min retirement age increases from 1999 on by 6 months per year. 60 with 35 years of pension qualifying period	55 with 30 years of pension qualifying period
Maluses	Permanent reductions for both by 0.3% for each month missing before reaching full retirement age.	
Entitlement by length of career	When reaching 40 (men) and 35 (women) years of pension qualifying period, the min retirement age is set at 55 years 6 months and 50 years 6 months respectively in 1999, and increased by 6 months per year until 2008.	
Extended insurance period	Extended insurance periods were retained for certain professions and personal conditions, which are determined by special law. This gives the right for a reduction of the retirement age from 1 year every 6 when a year is counted as 14 months up to 1 year every 3 when a year is counted as 18 months.	
Pension formula	1st pillar only	1 st and 2 nd pillar
Determination	Actual Pension Value (APV) x Personal Points (PP) x Pension Factor (PF)	APV x PP x PF (for service in old system) + basic pension (for service in new system) + 2 nd pillar annuity
Maximum and minimum benefits	Min pension: 0.825% of average 1998 gross wage per year of service Max pension: 3.8 average personal points per year of service	No min or max benefits

Indexation and valorisation	APV = 50% wages + 50% prices Pension = 50% wages + 50% prices	APV = 50% wages + 50% prices 1 st pillar pension = 50% wages + 50% prices Basic pension = 50% wages + 50% prices 2nd pillar annuity = CPI
Actual Pension Value (APV) ^a	Art.175 of the Pension Insurance Act does not give a precise definition, it just states that it will be calculated with respect to the attained level of pensions realised by December 1998.	
Personal Points (PP)	The average of the ratio between an individual's wage and the national average wage for each year of the calculation period, multiplied by total insured years and an initial factor that penalises early retirement. Instead of 10, 40 best out of total insured years will be taken into account. The calculation period increases from 1999 on by 3 years per annum, until 2009.	
Pension Factor (PF)	Depends on the type of pension. Old-age pension and early old-age = 1.00	
Basic pension	$0.25 \times \text{APV} \times \text{PP} \times \text{PF} + 0.0025 \times \text{WAGE (98)} \times \text{years of service in new system}$ $\text{WAGE (98)} = 1998 \text{ average national wage, indexed as APV}$	
Disability pensions	Major retrenchment was achieved through the elimination of disability benefits based on remaining work capability and the abolition of regional disability commission, which were sources of widespread abuses. The type of disability determines the PF.	
General disability	No residual capacity to work = 1.00	
Professional disability	Disability due to loss of professional capability = 0.6667 Disability due to loss of professional capability caused by work injury = 0.5 Professional disability paid during employment = 0.3333	
Survivor pensions	PF = 0.7 up to 1.00, in proportion to the number of dependent survivors	

^a *A fierce controversy commenced after the calculation of the initial APV (Kalajdžisalihović, 2003a), set at HRK 35.16 in 1999 (OG, 31/99), supposedly yielding a smooth transition between pensions attained in December 1998 and January 1999 (Anušić, interview). For details, see the following paragraphs.*

Source: Anušić, O'Keefe and Madžarević-Šujster (2003), Zakon o mirovinskom osiguranju (OG 102/98, 162/98), Potočnjak (1999).

The prospects of having to retire according to new, more stringent rules and the conversion of beneficiaries of temporary disability transfers based on remaining work capability into pensioners proper generated a retirement wave during 1999 (disability increased by 17% and old-age by 4.5%, see Tab. 4). Additionally, the minimum, service-based formula was set at a relatively high level, the 0.5% accrual rate being raised to 0.825% during the second reading of the Pension Insurance Act. Some 45% of new pensioners became eligible. In particular, farmers and self-employed started earning above-poverty line benefits. Deplorably, the impact on the broadening of coverage was minimal (Anušić, O'Keefe, and Madžarević-Šujster, 2003:29-31).

Even after minor restrictions to minimum pensions in 2002 (see Implementation of the funded pillars), the number of recipients steadily rose. By 2006 an average 0.9 pension points per year of work yielded benefits greater than the minimum only for 40 years of service or more.

Table 9 Old-age pensions on 1 July 2006

Insured wage as % of average wage	Pension qualifying period						
	15	20	25	30	35	40	45
35	266.49	355.32	444.15	532.98	621.81	710.64	799.47
80	609.12	812.16	1,015.20	1,218.24	1,421.28	1,624.32	1,827.36
90	685.26	913.68	1,142.10	1,370.52	1,598.94	1,827.36	2,055.78
100	761.40	1,015.20	1,269.00	1,522.80	1,776.60	2,030.40	2,284.20
200	1,522.80	2,030.40	2,538.00	3,045.60	3,553.20	4,060.80	4,568.40
max pension 380	2,893.32	3,857.76	4,822.20	5,786.64	6,751.08	7,715.52	8,679.96
min pension	738.30	984.40	1,230.50	1,476.60	1,599.65	1,722.70	1,845.75

Source: HZMO. Actual Pension Value (APV) = 50.76; min pension per year of pqp = 49.22 and 24.61 per year >30. The amounts in grey cells are supplemented to reach the min pension.

These developments, coupled with measures enacted by the incumbent HDZ and the subsequent SDP governments to honour the 1998 Constitutional Court's decision, again worsened, albeit only temporarily, pension-related spending.

2.5 The Funds Act and Annuities Law

As mentioned above, the Funds Act was rendered dependent on the Annuities Law, and both were passed during 1999. This only marginally affected the three postponements of the start date for second pillar contributions (from January 2000 to January 2002), which were instead caused by unrelated political and economic factors, whose individual causality links are impossible to establish.

In the political arena, the 2000 elections, the change in government and the reappointment of personnel in most agencies played a major role and altogether took over a year's time. Anđelka Buneta in the Central Registry of Insured Persons (Regos), Srećko Vuković in HZMO and Dragan Kovačević in the Agency for Supervision of Pension Funds and Insurance (Hagena) were all appointed because they were affiliated to the SDP (Matković, interview). In addition, there was an ongoing ideological clash. The old Plenipotentiary was disbanded in 1999 and a new one formed in early 2000, chaired by Deputy PM Željka Antunović (SDP), whose task was to evaluate the two laws economically and technically. By retaining WB official Zoran Anušić and other key actors, such as Snježana Plevko (later appointed deputy director of Hagena), continuity was ensured. The fact that the two laws had been opposed in the *Sabor* by the SDP was a cause for embarrassment, and Deputy

PM Antunović on various occasions claimed that changes would be introduced. However, no concrete action followed and the SDP quietly accepted the acts. In any case, it was plausible to foresee a deep rupture of relations with the World Bank, had the multipillar system been overhauled (Anušić, Mintas Hodak, interview).

On the economic front, instead, the 1998 Small (Restitution) Law, the 1999 recession and concomitant surge in pensioners, the 2000 Pension Increase Act (see text below) and the simultaneous reduction by 2% of both health care and pension insurance contributions (OG, 54/00) implied renewed apprehension for the coverage of transition costs. Under these circumstances, the two year postponement came as no surprise. Letting historical details aside for later paragraphs, the technicalities of both laws were left untouched until implementation.

Table 10 Funded pillars characteristics^a

Affiliation	Mandatory – under 40, choice of Mandatory Pension Fund by 31 March 2002 Voluntary – between 40 and 50, choice of MPF by 30 June 2002 Not allowed – over 50
Regulation of mandatory and voluntary pension funds	
Legal status	Neither MPF nor VPF are legal entities, they are just property with special status. Each has to be managed by a separate pension fund management company. Each management company can manage one Mandatory Pension Fund, while this limit does not subsist for Voluntary Pension Funds. Hagna grants licenses to managing companies.
Capital and membership requirements	Mandatory Pension Funds – 80,000 members by 3rd year of operations; initial capital HRK 40M Voluntary Pension Funds – 2,000 members by 3rd year of operations; initial capital HRK 15M
Guaranteed Rate of return	There is a rather low relative guaranteed rate of return, calculated by Hagna once a year. Reference rate of return = actual market-share-weighted rate of return RoR – 2% Guaranteed rate of return = Reference rate of return / 3, if > 0, Reference rate of return x 3, if < 0, subject to max discount rate by the Croatian National Bank (HNB)
Financing the guarantee	a) Guarantee deposit (unlimited) b) Base capital of the MPF management company (up to 20% of stock) c) State budget (unlimited) The guarantee deposit amounts to HRK 1M for every 10,000 members in excess of the 100,000 minimum affiliation and 75% of the success fee for each successive 3 year period.
Investment limits	There are limits by issuer and by asset class, both setting quantitative restrictions and investment prohibitions. The same rules apply to Mandatory Pension Funds and Voluntary Pension Funds. Among others, forbidden is all equity not traded at organised stock exchanges, derivatives, securities issued by persons affiliated to the fund management company or custodian. There is a 50% min investment requirement for state and HNB bonds and a 15% max investment limit for foreign securities.

Administrative fees	Upfront (membership) fee: max 0.8% front-end fee on paid-in contributions, collected every month by Regos Management fee: max 0.8% of Net Asset Value (NAV) per annum, calculated daily and collected monthly Success fee: max 25% of real annual returns, calculated on first business day in a calendar year as 25% real change in Net Asset Value (deducted previous year's consumer price index) The Net Asset Value is calculated by the custodian bank daily and it includes the custody fee, while the brokerage one is borne by the fund management company. Switching or exit fee: 5% total accumulation in 1st year, 2.5% in 2nd year, 1.25% in 3rd, 0.625% in 4th and 0.31% in 5th. Upon implementation, in 2002 one free switch was allowed.
Tax treatment and subsidies (see Notes)	Mandatory Pension Funds – EET or TEE, depending on the type of income from which contributions are paid. Pensions were taxed only for amounts greater than HRK 2,500. Voluntary Pension Funds – Tax deduction of up to 0.8 of the basic tax deduction, i.e. max HRK 1,000 monthly, cumulatively for voluntary pension, health and life insurance. Tax subsidy of up to 25% contributions paid, limited to HRK 5,000, that is max HRK 1,250 per annum.
Regulation of annuities and Pension Insurance Companies (PIC)	
Legal status	Pension Insurance Companies are specialised insurance companies, which can offer only pension-related products. Base capital is HRK 5M and HRK 1M is added for each 1,000 contracts. They can charge an up-front fee of 5% of total accumulation transferred from a Mandatory Pension Fund to a Pension Insurance Company. A surplus in technical reserves exceeding 15% of future liabilities has to be distributed to annuitants. Actuarial reserves have strict investment limits.
Retirement age	The same as in the Pension Insurance Act for old-age, early old-age, disability and survivor. Regos transfers the MPF share to a PIC chosen by individual.
Annuity type	Mandatory Pension Funds – Lifetime price-indexed annuity, four types: single, single with guaranteed period, joint-and-survivor and joint-and-survivor with guaranteed period Voluntary Pension Funds – programmed withdrawals, variable annuities, and combinations. There are various indexation options, as well as a lump-sum payout capped at 30%.
Longevity risk	Mandatory Pension Fund annuities are calculated on unisex life expectancy tables, which entail a redistribution from men to women. Longevity risk remains high. VPF annuities can use gender-specific tables.
Indexation	Mandatory Pension Funds – consumer price index, guaranteed by the state Voluntary Pension Funds – consumer price index, exchange rate or mixed

^a Some of these features were changed with subsequent amendments. Refer to later paragraphs.

^b EET (exempt, exempt, tax) means that contributions and investment income of reserves are exempted from income tax, while benefits are taxed.

^c TEE (tax, exempt, exempt) means that contributions are taxed, while investment income of reserves and benefits are exempted from income tax.

Source: Anušić, O'Keefe and Madžarević-Šujster (2003), *Zakon o obveznim i dobrovoljnim mirovinskim fondovima* (OG 49/99, 106/99), *Pravilnik o porezu na dohodak* (54/01).

A number of theoretical critiques to the envisaged solutions were voiced in business and academia. A brief summary includes:

Legal status – One of the main imperfections was the need to establish separate managing companies for mandatory and voluntary pension funds (Vlaić, interview). In such a small market, where there will in any case be a tendency towards agglomeration, this is rather burdensome.

Guaranteed Rate of Return – Despite being low, it was a considerable source of debate.²⁹ The reference rate of return is weighted according to market share (capped at 25%) and is diminished by 2% to eliminate the asymmetry around zero and reduce the prospects of guarantee activation. However, this only transferred the asymmetry onto the guaranteed rate of return. It would probably have been wiser to reduce the guaranteed rate of return rather than the reference rate (Bakić, 2002:442-444).

Investment limits – These were set at Draconian level (cf. Vitas, 1998:31), entailing the risk of running out of securities to invest in. Two peculiarities stood out. First, the required investment into state and HNB bonds was set at 50% of mandatory pension funds' assets, which is unprecedented in CEE. This choice was resultant upon the worsening economic situation of 1999. Initial calculations showed that first year's transition cost (contributions flowing into the second pillar) would amount to HRK 2.5B, while MoF Škegro claimed to have half that at his disposal. Thus the minimum, later overshoot by all mandatory pension funds, was just a shielding device (Anušić, interview). Second, investment in derivatives was disallowed, even though the exchange rate risk might be very high in a country where tourism is vital (Matković, 2002b).

Administrative fees – By any standard they were set at higher than customary levels. Switching was basically out of the question and the Anušić (2004:5) calculated the cost-related reductions in assets and yields as being higher than in all the countries analysed by Dobronogov and Murthi (2005:38).

Tax treatment – In addition to the complex Personal Income Tax Regulation (OG 54/01), the main flaw was the failure to introduce third pillar tax exemptions for employers, which are crucial for the development of voluntary pension schemes.³⁰

Pension Insurance Companies – Establishing separate institutions not yielding any profits for a long time was criticised by the business sector. However, the rationale behind it was that pension insurance supervision be separated from the rest, thereby avoiding cross-subsidisation of existing financial products (Anušić, O'Keefe and Madžarević-Šujster, 2003:55-56).

Few of these critiques were initially addressed and new distortions were even added, as often happens when political considerations start to matter. Many flaws became evident only during implementation, which kicked off in 2002. Notwithstanding, preparations for the funded pillar started soon after legislation was passed, since the two agencies responsible for data collection (Regos) and fund supervision (Hagena) had yet to be established.

²⁹ See Vitas (1998: 28-30) for general considerations on the incentive structure attached to the guaranteed rate of return and its eventual financing and Anušić, O'Keefe and Madžarević-Šujster (2003:41-43) for Croatia.

³⁰ See Zuber (2002) for a complete account.

2.5.1 The creation of independent agencies

A peculiar feature of Croatian pension reforms was the concomitant reorganisation of the revenue side of contribution collection. The latter suffered from major inefficiencies. Employers bore a heavy reporting burden by having to submit 20 different forms to various institutions, which exerted multiple controls and inspections. Administrative ineffectiveness was fuelled by overlapping tasks and parallel networks of data compilation (HZZO, HZMO, Tax Administration)³¹, which resulted in deficiencies in transparency, accountability and ultimately overstretched public audit functions (World Bank, 2002:3-4).

Hence, the revenue side rationalisation was for the Bank a necessary corollary to pension reforms. To this purpose, the 1999 Country Assistance Strategy (CAS) proposed and got through both a structural adjustment loan by 2002, amounting to US\$ 202M and a pension system investment project (PSIP) worth US\$ 35.6M, US\$ 27.3 of which were WB loans (World Bank, 2004: 53). The PSIP encompassed the following actions:

- capacity building for Regos and Hagen, including investment in goods, consultancy and training;
- capacity building for Regos and Hagen, including investment in goods, consultancy and training;
- implementation support for public revenue and funded pension reform, comprising database maintenance and operation for unified employer reporting, financing of Fina operational costs, technical assistance of public revenue institutional reform, development of the public debt market and control and enforcement functions of MoF;
- HZMO reform, increasing efficiency and effectiveness through restructuring of human resources management, training and IT;
- financing of a Project Implementation Unit.

The Croatian government took several important steps; however, the chosen reform path followed a puzzling course.

On the one hand, contribution collection was gradually incorporated into the Tax Administration within a clear centralisation strategy. In fact, the Tax Administration started very gradually in 1998-99 by incorporating unemployment contributions. With the establishment of the Single Treasury Account from July 2000, it assumed the enforcement of pension contributions for all but the self-employed and from July 2001 it started collecting all mandatory insurance contributions, taking HZMO and HZZO tasks over, including part of their employees. The unified control and enforcement of all payroll taxes was begun by mid 2002 and on-site control of second pillar contributions in January 2003. The Financial Agency (Fina), successor of the in 2002 renamed Institute for Payment Transactions (ZAP), continued physically to withhold contributions from employers (Bejaković, 2004:72-73; Zakon o poreznoj upravi, NN 67/01).³²

³¹ For valuable comments on the role of Hagen, I have to thank Mr. Toni Lukšić.

³² A byproduct of centralisation was the *de facto* inclusion of contributions into the budget, thereby depriving the tripartite HZMO boards, and hence trade unions, of any influence on the money disbursed for financing pensions (Milidrag-Šmid, interview).

On the other hand, decentralised supervision of pension insurance was developed by the World Bank as the only available choice, mainly as a consequence of other supervisory agencies (HNB, Commission for securities, Authority for the supervision of insurance companies and the Monitoring section of MoF) declining the possibility of taking on the task. Thus Hagenia was established at the end of 1999 for second and third pillar contributions only. Its subordination to the *Sabor* rendered it independent of government. Zoran Barac was appointed director. Its main tasks, as defined in the Funds Act, consisted in licensing and supervising MPF, VPF and respective management companies, as well as Regos. It was also in charge of implementing most regulation connected with funded pillars.

Additionally, inasmuch as Regos proved to be an extremely efficient institution, shaped as a central clearinghouse insulating employees from employers' pressures and clearly inspired by the Swedish pension reform (World Bank, 2000:2), the establishment of yet another data collection agency in a small country like Croatia was perceived as inefficient (Anušić, interview). In fact, the plan was to broaden the tasks of this institution and establish them within an existing organisation. While the former eventually worked out, the latter did not. Regos was as well founded in late 1999 and Saša Mađarević was appointed director. Its mandate was considerably widened during the following three years (OG 114/01; 153/02) to include the collection of data on all payroll contributions, taxes and surtaxes. Bejaković (2004:71) provides an overview of Regos tasks. These include: registration of the insured to second pillar funds, cross-checking of paid-in contributions with reports submitted by employers, maintenance of a central database able to provide information to MPF and authorised institutions on every single payment.

Such an expansion of tasks was in line with the creation of a single database for all Croatian public bureaus; however, negotiations with agencies that owned sufficient IT to manage this flow of information (especially the Tax Administration) invariably failed. Therefore, Regos and its minuscule staff remained isolated.

These were evident signs of fierce opposition on behalf of the public administration to a major rationalisation, which would have threatened the existence of hundreds of overstaffed and wasteful offices. Ultimately, bureaucracy got the upper hand (see following paragraphs).

2.6 HDZ's last stand

During the second half of 1999 there were mounting premonitions that the incoming electoral bout would usher a radical change into the Croatian political landscape. The 2000 elections were the first to be disputed after the *Sabor* served full term, and were at the same time the first ones when the HDZ appeared weakened and faced a relatively united opposition, the six-party coalition or 'šestorka'.

The weakening of HDZ was a combination of various factors. The continuous scandals unveiled by the independent press regarding 'crony capitalism' and its failures (Bićanić and Franičević, 2003:16-19), the Zagreb crisis and demonstrations pushed the incumbent government beyond salvation. The main blow was the deteriorating health of President Tuđman – he had been diagnosed with cancer in 1993 – who passed away on 10 December 1999 and whose death led to the postponement of the elections until 3 January 2000.

The demoralisation was such that not even the customary tinkering with electoral rules worked. This time, the first-past-the-post system was all but abandoned, favouring an entirely proportional system with a 5% threshold. The Croatian territory was divided into 10 gerrymandered constituencies, plus one set aside for émigrés. Ethnic Serbs were given a single seat. The whole campaign was uneventful, leaving in the end little doubt on who the winner was likely to be.

The 'šestorka' was a six-party coalition with the HSLs and SDP at the core, and four other parties, a centrist block, backing up: the Croatian Peasant Party (HSS), Istrian Democratic Assembly (IDS), Liberal Party (LS) and Croatian People's Party (HNS).³³

The election results were very favourable for the coalition: the SDP and HSLs got together 38.7% of the vote and the 'šestorka' obtained 96 out of 151 seats in the *Sabor*. The new government was formed by PM Ivica Račan (SDP) on 27 January 2000 and comprised ministers from all coalition partners.

2.6.1 Pensioners' role

A major difference between the 2000 and 1995 elections was the mobilisation of pensioners as a single-issue constituency, amounting to roughly ¼ of the whole electorate (4,177,495, of which there were 3,827,123 in Croatia and 350,372 émigrés). Alojz Malogorski, president of the House of Croatian Pensioners, repeatedly claimed that pensioners could be pivotal in deciding electoral results (Matković, 1999a).

The different stance of the incumbent HDZ and 'šestorka' was evident. Pensioners deeply resented how HDZ dealt with the 1998 Constitutional Court's decision (see page 2).

During repeated appeals of top party representatives (Mate Granić, Vladimir Šeks, Nikica Valentić, Milan Kovač) and in the HDZ's electoral programme '*Sve za Hrvatsku*' (All for Croatia), statistics on consumption were presented, trying to dissipate the common belief that life under socialism was better (Jureško, 1999; Matković, 1999c). Ivo Kujundžić, HDZ Pensioners' Union, directly challenged the Constitutional Court's President Jadranko Crnić, who claimed that HDZ did nothing for retired people during its last mandate (Matković, 1999f).

The response by pensioner associations was univocal. Malogorski, Ivan Nahtigal (Union of Croatian Pensioners) and Ivan Maričić ('Croatian pensioner' Association) signed a common declaration on the realisation of pensioners' acquired rights and on the amelioration of their life conditions and quality of life – the social agreement – with SDP and HSLs representatives and their coalition partners.³⁴ Despite pensioner associations being autonomous, they opted for a political approach. In fact, they exhorted pensioners to vote "according to their own will", or, alternatively, for "the signatories of the social agreement" (Matković, 1999e).

Vjesnik inquired into the reasons for not signing a similar accord with HDZ. The answer was straightforward: the HDZ's main candidate was former PM Nikica Valentić,

³³ After Tudman's death, in 2000, the HSLs and SDP nominated their own presidential candidate, Dražen Budiša, who lost the elections against Stipe Mešić, the candidate of the other four.

³⁴ In addition SUH was already associated with the 'šestorka' through the SSSH, which had already signed the agreement for an equitable Croatia (Matković, 1999d).

who devised the 1993 stabilisation package, thereby becoming the main culprit for pensioners' deteriorating social position.

2.6.2 Honeymoon and separation

Despite the sweeping victory that marked the moral and electoral defeat of HDZ, which got 26.66% of the vote sliding back by almost 20 percentage points, and the undeniable merits of pensioners' support (turnout was a whopping 76%), the social agreement was a blessing in disguise, since it haunted the new incumbents throughout their entire mandate.

The content should have warned the 'šestorka' of the agreement's feasibility under severe fiscal constraints. The winning coalition agreed, among others, to implement the Constitutional Court's decisions regarding indexation of pensions during 1993-95³⁵ and indemnification for further devaluation, to decouple social assistance from pension insurance, secure the timely payment of pensions before the 5th in any given month and, last but not least, to put the homes for the elderly back under the aegis of HZMO.

Of course, the importance attached to these requests varied, however, failed indexation between October 1993 and December 1998, rather than claims for other outstanding arrears, was of top priority. The timing proposed within the social agreement, albeit motivated by the fact that average pension fruition was 15 years and that soon most of the injured pensioners would be dead (Matković, 2000c), was unrealistic as well: the *Sabor* had six months to pass a pension debt law, while full indexation had to be achieved in two years' time, starting in 2001.

The newly elected Minister of Labour and Social Welfare, Davorko Vidović (SDP), presented a repayment plan in June 2000, which valued the outstanding debt at HRK 22.7 billion cumulatively over the period 2001-2010. While only harmonisation of different calculation bases was covered, it was a realistic plan, given existing budget restrictions. The final version, the Pension Increase Act (OG 127/00), relied on cash transfers, earmarking some 2.15 billion kuna per year, and tried to squeeze relative pension increases into the figure. Benefit raises were between 20% and 0.5%, depending on the year of retirement and reference salary, while the Pension increase act took effect from January 2001.

The first proposals were greeted relatively warmly by pensioners, however, they were regarded as partial solutions, falling short of expectations, i.e. consistent wage indexation for the missing years.³⁶ Thus, after stalling, the situation went downhill. There was a number of unresolved problems that pensioner associations and some coalition partners (*IDS in primis*) blamed the government for.

Despite the effective increase in NRR during 2001 (see Tab. 7), these were average rates to avoid calculation for each individual pensioner. Lower pensions entitled to a 'safeguard supplement', as an effect of the increase, either lost this right and effectively expe-

³⁵ Pensioner associations requested compensation for failed pre-indexation during 1991-92 as well. The working group within the Ministry of Labour and Social Welfare, however, ruled it out (Matković, 2000b).

³⁶ Fulfilling such demands would have cost the state HRK 140-210 billion over 10 years, that is between 92-138% of Croatian GDP in 2000 (calculations vary).

rienced lower raises or retained it and did not register any change. The same happened to those receiving a minimum pension due to insufficient contributions (Matković, 2000d).

Not unexpectedly, pensioner associations were dissatisfied. In addition to the positive nature of the dispute, there was a normative one. Art.1 of the Pension Increase Act directly addressed the fulfilment of the 1998 Constitutional Court's decision, which was deemed unacceptable. Their appeals were swiftly turned down by the same Court (NN 03/02).

2.7 'Decisive... perhaps'

This unforgiving phrase was used to describe both PM Račan's governments. The second one was constituted in July 2002, after the HSLs broke away from the coalition. Račan was a reformist, but could not rein in the factional 'šestorka'. The main disagreements with Dražen Budiša, leader of HSLs, broke out on the ICTY indictments against Croat Army generals and on the co-ownership of the Slovenian nuclear plant in Krško, which ultimately tore the coalition apart.

In pension affairs, SDP never found a balance between populism and fiscal austerity. A sequence of contradictory acts characterised the 'petorka' period³⁷, the ones clamping down on interest groups overshadowed by those disbursing favours.

SDP gave in to a series of demands, which effectively set in motion the populist decay that followed the rebirth of HDZ under PM Ivo Sanader. After fulfilling some pensioners' requests, Račan surrendered to both his own parliament and to the nascent pension fund lobby. However, the rising problem concerning new pensioners' falling net replacement rate was ignored and even aggravated, for obvious fiscal reasons. Pensioner associations again felt disenfranchised and turned away from what was left of the centre-left government.

SDP's well-intentioned future reform plans, the strategy for the development of the Republic of Croatia: 'Croatia in the 21st century' (NN 97/03), remained *lettre morte*.

2.7.1 All pensioners are equal, but some pensioners are more equal than others...

As mentioned above, SDP governments dealt with merit pensions very inconsistently. This elicited major rancour by ordinary pensioners, who deemed them emblematic of HDZ policymaking and in dire need of reorganisation.

On the one hand, measures were issued limiting maximum pensions for MPs and veterans to twice the maximum ordinary pension (NN 82/01) and directly diminishing benefits for privileged categories by variable amounts ranging from 8 to 20%.³⁸ In addition, the SDP tried to deprive the combatant status of its overestimated dignity and to monitor regional committees responsible for assigning privileges, operating under the Ministry for Homeland War Combatants (Puljiz, interview), however, the precarious balance between international demands (collaboration with ICTY) and domestic political stability, probably prevented more radical moves.

³⁷ From July 2002 until December 2003, a five-party coalition governed and HSS became SDP's main coalition partner.

³⁸ This implied the amendment of the Pension Insurance Act and various special laws.

On the other hand, earlier during the period of office, eligibility of MPs to benefits was rendered even laxer.³⁹ This created an overwhelming chorus of disapproval (Goreško, 2000). Even HDZ had been aware that the *Sabor* should not unnecessarily play with this issue. Appeals to the Constitutional Court followed, but the latter found no infringement of the Constitution when the government grants certain privileges and is prepared to pay for them (via the budget).

2.7.2 The deepening cleavage

Another blow to those retiring under the Pension Insurance Act was a further tightening of eligibility criteria.

Public opinion was shocked to learn that the SDP curtailed minimum pensions. Cuts were far from radical, however, the accrual rate for each pension qualifying year above 30 was halved from 0.825% to 0.4125% and maluses for early retirement were increased to 0.34% per month, totalling 4.08% *per annum*, up to a maximum permanent decrement of 20.4%.

At the same time, following a dispute with pensioner associations over the prolongation of the 100 kuna + 6% supplement, granted in 1998 by the HDZ, the government gave in. The supplement was maintained, but not entered into the calculation base or included for indexation (OG 147/02).

Ultimately, the consequences were rather inauspicious. The social security system was turned into a lottery in the eyes of the public, due to swift implementation of stricter conditions and the progressive elongation of the calculation period (Goreško, 2000). In addition, retaining supplements strengthened the basis for later demands for equalisation of 'old' and 'new' pensions.

2.8 Implementation of the funded pillars

Fervid legislative production regarding contribution rates preceded implementation of the funds law. After the rates were diminished by 2% in 2000, the system was fine-tuned in December 2002 (OG 147/02). Minimum and maximum contribution bases were established, amounting respectively to 35% and 600% of the average wage. The upper limit rendered the system symmetrical, since the maximum pension amount (3.8 pension points per year) elicited much contribution evasion. In addition, contributions were fixed at 20% – 15% to the first and 5% to the second pillar – and entirely charged to employees.⁴⁰

In order to minimise further delays, the temporary licensing of mandatory pension funds and related management companies started in October 2001.⁴¹ By mid-November,

³⁹ Serving half a term, an MP can retire at 55 (men) or 50 (women) and 20 years of pension qualifying period; serving three terms (at least two years in each), 15 years of pension qualifying period. The minimum pension cannot be lower than 65% of the last salary, thus twice the maximum ordinary benefits (NN 55/00).

⁴⁰ This change was probably dictated by the boundedly rational perception of contributions by employees. Even though the fiscal result does not change, employees' awareness potentially increases when they are directly faced with the whole contributory burden.

⁴¹ There were delays with the licensing of custodian banks, as conflict of interest legislation was very restrictive, since no affiliation with MPF managing companies was allowed. HVB Croatia, Hypo Alpe Adria Bank and Hrvatska Poštanska Banka were ultimately licensed.

registration of members commenced. Contributions were planned to start in January 2002. Regos outsourced registration operations to branch offices around the country belonging to ZAP (later Financial Agency).

The insured below 40 were given time until 31 March to choose a mandatory pension fund and those failing to do so were randomly redistributed by Regos to the funds according to market share. The correspondent contributions were 'parked' into an account of the National Bank of Croatia and earned the HNB discount rate of 5.9%. The selection period for affiliates aged between 40 and 50 lasted until 30 June.

In order to raise rather low public awareness, a major education campaign was launched by Croatian pension reform institutions, financed by USAID and implemented by Carana Corporation. It was an undeniable success. In the last months of 2001 public awareness grew from 32% to 81%, while 82% of the surveyed entirely or mostly supported reforms and over 88% chose their own MPF, instead of being allocated to one by Regos (Hurd, 2003:5). As Anušić, O'Keefe and Madžarević-Šujster (2003:37) point out, the campaign first focused on the functioning and promotion of the second pillar, and from November 2001, on registration procedures.

The final results were, however, mixed. By July 2002, the seven licensed mandatory pension funds counted 837,237 new members, of which 721,177 were under 40 and 116,060 aged between 40 and 50 (Androić, 2002). The latter figure represented a failure: instead of a 50% affiliation rate for this age group, less than 1/3 registered. This result was probably determined by two factors: a) distrust by Croats following major financial crises; and b) on-line programs, such as those provided by Hagen, showing that multi-pillar pensions yielded lower benefits than public pillar ones.

2.8.1 The marketing campaign

Notwithstanding an expensive marketing campaign – HRK 120 million, or 32% of total charter capital of the industry – the excesses seen in Poland⁴² were not repeated and violations were rare. Stringent marketing rules (Chłóń-Domińczak, 2003:33-34), coupled with privacy of fund selection and Croatian conservatism, implied that direct marketing had almost no correlation with resulting membership (Anušić, O'Keefe and Madžarević-Šujster, 2003:59-60).

The brands of banks involved in the management of pension funds (see next paragraph) were the most important factor affecting choice. Zagrebačka banka, Raiffeisen Bank and Privredna banka Zagreb (PBZ) instantly attracted almost 90% of all members, raising widespread oligopoly concerns.

As the market structure consolidated in the following years, these worries appeared increasingly well-founded and were definitely fuelled by the indifference displayed at governmental level. Further amendments to legislation only worsened the problem.

⁴² With respect to the legislative process, Croatia, Poland and Romania reformed pensions almost simultaneously at the end of the 1990s. Subsequently, Poles were the fastest to implement, followed by Croats, while at the time of writing, Romania is still struggling. Learning effects should not, therefore, be ruled out.

2.8.2 Evolution of the market

By January 2002, Hagenal licensed seven mandatory pension funds and relative management companies. Of these AZ, PBZ/CO and Raiffeisen very soon attained the 80,000 member minimum threshold, while Erste, Plavi, Helios and Ha-jedan did not.

As a consequence of financial scandals, Erste banka bought Riječka banka, one of the co-owners of Plavi MPF. Since having stakes in two MPF was not allowed, Hagenal approved the merger of Erste, Plavi and Helios into the Erste Plavi fund (Matković, 20-03b). Ha-jedan, the MPF established by the Trade Union of Public Employees, among others, was outclassed by competitors as it managed to attract only 0.35% of total members, despite its marketing expenditures being greater than the annual contribution inflow. After considering conversion into a VPF, Hagenal authorised its takeover by A-Z (Hina, 2003). Since then, the Croatian mandatory pension fund market became almost consolidated: four mandatory pension funds survived and the situation remained unchanged as of 2007.

Table 11 Ownership structure of Croatian Mandatory Pension Funds

Name	Managing company	Foreign owners	Share in %	Domestic owners ^a	Share in %
AZ	Allianz ZB d.o.o.	AZ - Argos 2 GmbH (Germany)	51.00	Zagrebačka banka, d.d.	49.00
Erste Plavi	Erste, d.o.o.	TBIH Financial Services Group NV (Netherlands)	29.00	Istarska kreditna banka, d.d.	2.47
		Erste Bank der Österreichischen Sparkassen AG (Austria)	12.38	Erste & Steiermärkische banka, d.d.	27.87
		Steiermärkische Bank und Sparkassen AG (Austria)	12.05		
		EBRD (UK)	10.06		
		Zavarovalnica Triglav d.d. (Slovenia)	6.17		
PBZ Croatia osiguranje	PBZ Croatia osiguranje, d.d.			Privredna banka Zagreb, d.d.	50.00
				Croatia osiguranje, d.d.	50.00
Raiffeisen	Raiffeisen mirovinsko društvo, d.d.			Raiffeisenbank Austria, d.d.	100.00

^a Croatian branches of foreign companies are included among domestic owners.

The following tables present membership, contributions, returns on 31 December 2005 and relative flows during the year.

Table 12 Membership, contributions and returns in 2005

	AZ	Erste Plavi	PBZ/CO	Raiffeisen	Total
Members 31 Dec 2004	462,291	126,768	194,494	380,091	1,163,644
First registration	3,082	1,373	3,338	3,396	11,189
Additional registration	1,984	635	2,001	1,803	6,423
Regos allocation	27,772	7,730	11,836	22,931	70,269
New members total	32,838	9,738	17,175	28,130	87,881
Switches from other mandatory pension funds	772	4,939	2,685	3,152	11,548
Switches to other mandatory pension funds	5,230	1,369	1,765	3,184	11,548
Net change	- 4,458	3,570	920	- 32	–
Membership termination	892	317	573	808	2,590
Members 31 Dec 2005	489,779	139,759	212,016	407,381	1,248,935
Membership share in %	39.2	11.2	17.0	32.6	100
Net contributions ^a	1,306,286	307,675	531,811	964,515	3,110,287
Transfers from other mandatory pension funds	3,119	28,597	15,006	18,317	65,038
Transfers to other mandatory pension funds	31,010	8,077	9,518	17,049	65,653
Corrective payments	925	174	230	663	1,991
Termination payments	7,104	2,232	5,173	6,140	20,650
Gross rate of return in %	7.69	8.62	8.12	9.19	8.34
Calculation unit 31 Dec 2004	124.01	125.40	127.17	126.14	125.35
Calculation unit 31 Dec 2005	131.28	135.49	133.22	138.12	134.20

^a All amounts are expressed in thousands kuna.

Source: HANFA (2006: 106-108).

Table 12 shows a clear cleavage between the two bigger funds (AZ and Raiffeisen) and the smaller ones (Erste Plavi and PBZ/CO). This imbalance is probably responsible for suboptimal effectiveness of the pension fund lobby and a tendency for oligopolisation in the market. However, performance of the funds was rather satisfactory and artificially boosted by government bonds yielding favourable returns. In fact, portfolio investments are heavily imbalanced and render the 50% minimum investment into treasury bonds requirement redundant, see Tab. 13.

Table 13 Overall portfolio structure (in thousands kuna and %)

Asset class	31 Dec 2004		31 Dec 2005	
	Amount	Share in %	Amount	Share in %
Domestic assets	7.498,547	92.75	10.673,953	89.01
Securities and deposits	7.174,461	88.74	10.294,567	85.85
shares + global depositary receipts	279,148	3.45	333,484	2.78
government bonds	6.210,223	76.82	8.709,190	72.63
municipal bonds	66,697	0.83	60,016	0.50
corporate bonds	521,763	6.45	442,878	3.69
closed investment funds	0	0.00	0	0.00
open investment funds	0	0.00	258,985	2.16
short-term securities	59,953	0.74	163,563	1.36
deposits	36,676	0.45	326,450	2.72
Cash	221,129	2.74	148,781	1.24
Credits	102,957	1.27	230,604	1.92
Foreign assets	585,955	7.25	1.318,030	10.99
Shares	62,982	0.78	134,902	1.12
Government bonds	41,257	0.51	208,561	1.74
Municipal bonds	0	0.00	0	0.00
Corporate bonds	57,855	0.72	52,765	0.44
Closed investment funds	0	0.00	0	0.00
Open investment funds	423,862	5.24	921,801	7.69
Short-term securities	0	0.00	0	0.00
Deposits	0	0.00	0	0.00
Total assets	8.084,502	100.00	11.991,983	100.00
Net assets	7.913,238		11.714,215	

Source: HANFA (2006: 107).

Various deficiencies in the laws governing the third pillar (lack of incentives for employers) and maybe low public awareness prevented the voluntary funds from taking off. By the end of 2005 there were six open-end and five closed-end voluntary pension funds on the Croatian market. Open-end voluntary funds showed promising developments as membership rose by 70% to 51,158. Closed-end voluntary funds totalled only 5,336 affiliates.

2.8.3 The iron law of oligarchy

As soon as implementation started, various incongruities in the Funds Law emerged. In order to lobby the government and especially the regulator, Hagen, the MPF management companies very early established the 'Association of Croatian Pension Funds Management Companies and Pension Insurance Companies' at the Croatian Chamber of

the Economy and put in place an annual presidency rotating system. The Association became also a member of the European Federation for Retirement Provision, which, however, bore little importance for the group due to the focus of EFRP on the application of the IORP directive. The latter in fact affects only occupational schemes, which still play a negligible role in Croatia (Vlaić, interview).

During nearly weekly appeals on the press, the presidents of MPF management companies, individually or through the Association, outlined some of the issues in need of improvement. Their requests mainly focused on the broadening of investment into derivatives (even just futures), foreign securities and equity traded on less regulated markets.⁴³

Practically, the lobby, despite its carefully planned organisation did not prove extremely successful. Less than half of its demands were fulfilled; however, the SDP introduced a significant revision of administrative fees and various requirements in June 2003, just before the elections (Zakon o izmjenama i dopunama Zakona o mirovinskom osiguranju, NN 103/03).

Table 14 Second pillar adjustments

Licensing	Mandatory pension funds – 50,000 members by 3rd year of operations Voluntary pension funds – 200 members by 3rd year of operations
Switching	0.8% total accumulation in 1st year, 0.4% in 2nd year and 0.2% in 3rd.
Success fee	Repealed.
Management fee	max 1.2% of net asset value per annum
Guarantee deposit	HRK 1M for every 10,000 members in excess of the 50,000 minimum affiliation

Source: NN 103/03.

Thus, licensing requirements were relaxed, the excessive switching fee drastically reduced and the success fee repealed. However, as a compensation, probably also for failed increase in contribution diversion, the management fee was increased to 1.2% of NAV, which is the world record (Anušić, interview).

At first glance the situation seems under control, and yet, in a *Rumsfeldian* world of known unknowns, the devil lies in the detail. This amendment to the Funds Law only exacerbated the furtive oligopolisation of the system and exasperated the cleavage between bigger and smaller mandatory pension funds. The process is a subtle version of policy drift (Hacker, 2005). Five factors constitute the mechanism (Vlaić, interview):

- given the small Croatian market, membership requirements (even 50,000) effectively represent an insuperable barrier to entry;⁴⁴

⁴³ Only first quotation was allowed, while public joint-stock companies (JDD), which have only marginally lower trading standards, were excluded. By 2007 there were just seven companies listed on first quotation, six on the Zagreb stock exchange and one in Varaždin. For details, see <http://www.crosec.hr/registri.asp> [cited 17 March 2007].

⁴⁴ In 2006, there were rumours of further relaxation of mandatory membership requirements.

- registration through Fina branch offices is useful, but due to Croatian geography (there are more than 1,000 islands), it is suboptimal as many potential switchers are deterred. Tab. 12 shows how the few members that switched funds moved to the MPF where returns were highest, i.e. Erste Plavi and Raiffeisen in 2005 (Matković, 2006d);⁴⁶
- new members who fail to select an MPF are automatically assigned by Regos to funds according to their market share. This crystallises the initial situation, and pushes the MPF management into apathy, since success- or merit-based competition is emasculated;
- the successful education campaign was discontinued after 2002, meaning that new participants are poorly informed and hence very few (roughly 1/5) choose a MPF, thereby worsening the problem above;
- the change in the fee structure further weakens the incentives for good management, as larger funds make fat returns by cashing in the increased management fee. In smaller funds, return on equity (ROE) fell to around 10%, a very low figure barely securing survival.

These determine a rupture in the lobby's unity, since the smaller funds develop considerably different interests than the bigger ones. The prospects are rather bleak, as competition may be completely annulled via aggressive marketing by larger funds. However, the projected change in the redistribution formula may unleash even more aggressive marketing strategies, if larger funds' share falls (Latković, interview). In a market consisting of only four funds, any further concentration will imply a failure of World Bank policies, making the privatisation of the pension system simply too costly in its redundancy.

2.9 The 2003 election

During 2003, the incumbent SDP and what was left of its crumbling coalition found themselves, with respect to pensioners, in a position roughly similar to that of the HDZ in 1999. Of course few of the scandals and abuses that characterised the previous government were replicated, however, PM Račan and especially MoL Vidović had to stand up for their accomplishments, which were though in an indefensible position.

In fact, pensioner associations' *leitmotiv* was that neither the previous, nor the current government extinguished their debts: the HDZ by negating the Constitutional Court's 1998 decision and SDP by not fulfilling the 1999 pre-electoral agreement. The incumbents' assertions that they repaid each pensioner some 7.6 out of 24 pensions making up the debt created by HDZ sounded absurd (Hina, 2003), given the appalling levels of poverty among the elderly.

At first, MUH and SHU intended to retry the pre-electoral agreement card by sending their requests to all passable coalitions (Matković, 2003a); however, after being courted by most parties with all sorts of promises, they decided to run unitedly and independently. If successful, they would become the first socially homogeneous interest group represented at parliamentary level in Croatia. A common declaration signed by most pensioner associations delegated representation to Vladimir Jordan's HSU, which presented candidates in each of the 11 districts (Matković, 2003c). Among these figured association leaders such as Ivan Nahtigal and Vladimir Lokmer. HSU presented its quixotic programme in November.

⁴⁵ On the other hand, Latin American excesses are avoided.

The elections held on 23 November 2003 witnessed a convincing, but not overwhelming victory by HDZ. Nonetheless, the main surprise were the three seats obtained by HSU, which fell short of the 5% threshold by a few hundred votes in another three districts. HDZ obtained 66 seats (62 at home and 4 from émigrés) and needed another 11 to have a majority in the *Sabor*. Three out of those 11 votes got to be known as the dearest in Croatian history.

2.9.1 Post-electoral horse trading

The pressure exerted by three HSU MPs on the HDZ was nothing short of blackmailing. Two factors accounted for this course of events. On the one hand, the mere fact that HDZ needed HSU votes was entirely fortuitous, and on the other, once this trend was established, there was no coming back: unless pensioners' requests were fulfilled, HSU would have probably gained in strength at each subsequent election.

Ivo Sanader's main problem became finding a suitable coalition partner, because each of the three plausible options became suddenly unavailable. The HSLs-DC coalition underwent a major defeat and was thus out of the game. The Croatian Party of Right (HSP) was not acceptable in light of the EU accession process due to its radical right status. The HSS was just about right, but when its president Zlatko Tomčić proposed the deal, the party almost split up. Thus, after co-opting a few defectors and representatives of national minorities, Sanader signed an agreement of support with pensioner representatives (Latinović, 2003).

2.10 Sanader's government and institutional degeneration

Very soon, the newly elected HDZ government showed its populist face, despite proving a strong advocate of EU membership and capable of compromise on thorny Homeland War-related issues (Fisher, 2006:195-196).⁴⁷ In fact, the *cadeaux* promised to other coalition partners and external supporters (HSS, HSP etc.) paled in comparison to the HDZ-HSU agreement. The three votes for the election of PM Sanader's minority government on 23 December 2003 entailed:

Table 15 The HDZ-HSU agreement

Within the first 100 days of government	resumption of wage growth indexation
	inclusion into the pension base of the 100 kuna + 6% supplement
Until 30 June 2004	submission of a law settling the obligations deriving from the 1998 Constitutional Court's decision
	submission of a law providing for additional yearly indexation to GDP growth until NRR reaches 70% (intermediate objective 50% by January 2005)
During 2004	amendments to the Pension Insurance Act to improve retirement conditions of pensioners not falling under the funded pillar
	redefinition of the membership of the HZMO Board
	total exclusion of persons older than 65 from medical and medicine expenses

Source: HSU, 2003.

⁴⁶ However, threats of further postponements of EU accession negotiation played a major role here.

Probably, not even dedicating the whole parliamentary agenda would have been sufficient to meet all these demands.

2.10.1 Grey lobby

From the formation of PM Sanader's government in December 2003, until the local elections of May 2005, when HDZ managed to secure votes by HSP and *de facto* breach the agreement with the Croatian Pensioners Party with impunity (Matković, 2005b), the public pillar got captured by pensioner associations.

The sequel of fulfilled demands started with great fanfare in February 2004, when a common pensioners-government committee was established by HSU leader Vladimir Jordan and Sanader's inner cabinet, comprising deputy PM Jadranka Kosor and Andrija Hebrang, and the Ministry for the Economy, Labour and Entrepreneurship Branko Vukelić (Matković, 2004a). The committee produced a major amendment to the Pension Insurance Act already by March 2004 (OG 30/04), thereby resuming wage-based indexation, including the 100 kuna + 6% supplement into the pension base and redesigning the HZMO Board.⁴⁸ Additionally, the Personal Income Tax Act was amended and the tax exemption for pensions was raised from 2,550 to 3,000 kuna. Health care contribution exemptions were broadened as well (Matković, 2004b).

These concessions marked the peak in government-pensioner associations relations, which afterwards witnessed a rapid deterioration, due to the fiscal impossibility of financing their excessive demands. Interestingly, the pivotal role in the debate that took place around the restitution of the debt and the other points of the Agreement was played by the IMF. Both Dimitri Demekas, the South-eastern Europe Division chief, and Athanasios Vamvakidis, the IMF permanent representative to Croatia, repeatedly pointed out that while the pensioner debt constituted a vested right due to the Constitutional Court's decision, wage indexation was purely political and, of course, unsustainable (Matković, 2004c).

The US\$ 141 million stand-by arrangement signed in August 2004 weighed heavily on PM Sanader's future choices. Expectedly, the additional, yearly indexation to GDP was not even contemplated and, in July 2005, indexation based on the 'Croatian formula' was put back into place (OG 92/05). The HSU was very disappointed, however, it did not terminate collaboration with HZD. In fact, talks on the restitution of the pensioner debt were still underway and the 'new' versus 'old' pensioner affair was only starting to swell up.

2.10.1.1 An imaginative solution

The first step towards the assessment of the pensioner debt was the Pensioner Fund Act of July 2005 (OG 93/05), which established a pensioner fund to be filled by state assets and budget transfers with the exclusive aim of carrying out the 1998 Constitutional Court decision. The fund was to be managed by HPB Invest. The rest of the year was spent debating on how to render repayment effective.

⁴⁷ The original Pension Insurance Act foresaw 7 members appointed by the government and 2 each by pensioner, insured and employer associations. The new amendment, instead assigned 4 members to the government and 3 to each association.

In November 2005 PM Sanader proposed the following solution: a) a swift repayment in four instalments over two years (from June 2006 until December 2007) of half of the entire amount; b) a slower reimbursement in six yearly instalments from 2007 until 2012 of the whole amount. Of the 426,309 out of 677,411 pensioners who became eligible, 74% chose the swift method and 26% the slower one. The latter figure was much higher than what the government hoped for – less than 5% - and raised the pensioner debt bill from HRK 8 billion up to HRK 13.8 billion (HZMO, 2007). The IMF did not endorse the manoeuvre, since the amounts needed for the first instalment, if not realised through privatisation revenues, may have destabilised public finances, thereby creating larger than expected budget deficits (Bejaković, 2006).

The end of the pensioner debt saga was written in 2007, when the government, after major protests by HSU and various pensioner associations, gave in to the reimbursement of the debt incurred for survivor and maximum pensions, which were previously excluded. This added another HRK 1.4 billion to the pensioner debt bill, to be paid to 43,781 beneficiaries (3,093 of whom were receiving maximum pensions until 31 December 1998).

2.10.1.2 'New' versus 'old' pensioners

The main reason the HSU did not cease to cooperate with the HDZ, despite its not being anymore vital for the coalition is the unresolved issue of the falling purchasing power of 'new' pensioners.

At the heart of the problem lies the initial computation of the APV to guarantee continuity between pensions calculated according to the old and new formulas, which was used as an obfuscation element to pass the Pension Insurance Act. Milidrag Šmid (interview) claims that APV was determined in line with the 1998 *niveau* of average pensions, not including supplements. To do this and comply with ILO Convention 102 (a 40% minimum NRR with respect to net wages qualified male workers), average wages in construction work, which was, like textiles in dire straits in 1998, were used.

A quick comparison of Tab. 9 and Tab. 16, shows that the gap between 'old' and 'new' pensioners is deteriorating fast: while in 2002 some 26% of new pensioners were granted the minimum pension supplement, this figure rose to 67% by 2005 (Matković, 2006b). Interpretations of the causes, however, differ, or better, are complementary. The World Bank argues that supplements make for much of the difference, while the 'grey lobby' claims that the increasingly stringent formula (longer calculation period etc.) is fully responsible.

Table 16 Insured in both pillars, with respect to pension base

Yearly averages	Pension base				Total number of insured
	$X \leq \text{min base}$	$\text{min base} < X \leq \text{average wage}$	$\text{average wage} < X \leq \text{max base}$	$\text{max base} < X$	
2005	52,171	692,055	389,875	3,102	1,137,201
2006	40,641	705,566	410,438	3,472	1,160,171

Source: HZMO. The min pension base is 35% of the average wage and the max base is 600% of the average wage. The total number of insured is lower than that reported by pension funds, because here only those insured who effectively paid in contributions during reference periods are counted.

Whichever the case, the result is that the 'grey lobby' reunited in the attempt to correct this downward trend, by proposing a whole series of correctives: shorter calculation period, *ad hoc* increases, new computation of the APV and a higher minimum pension – for example equal to 40% of the average wage (SSSH, 2006). It is interesting to note that Piersonian obfuscation and division tactics may virtually exclude an interest group from a deliberative arena, just to render it stronger in the following one, as Orenstein would have it. In this case, previously divided and uninterested trade unions united forces in the pursuance of 'new' pensioner interests.

The salience of perceived inequality between the two cohorts gained in prominence as the electoral year 2007 approached. In May 2006, HSS had already sent to parliament an amendment to the Pension Insurance Act rectifying the situation. Theatrically, PM Šanader's government fully endorsed the issue only months later, and by October 2006 a new working group was established. The SDP followed suit in November, when it presented its own proposal. The details of a renewed pension reform, which would hinge on the use of increased budget revenues (estimated to be rising at an incredible 12% *per annum*) to bridge the gap between 'new' and 'old' pensions – by for example setting up an investment fund – were not spelled out; however, social partners and pensioner associations were invited to join a public debate (Lipovac and Oruč Ivoš, 2006). As Anušić put it, if such a reform passed, and it will, the chances of increasing contributions to the second pillar will probably disappear.

A less debated, but equally worrisome corollary to this populist surge is the not yet quantified multiplication of Homeland War combatants granted disability status, often as a result of Post-Traumatic Stress Disorder (PTSD). Almost half a million relatively young men, entitled to very high benefits, could in a few years suck public finances dry and the blame should, according to Professor Puljiz (interview) be laid entirely at the door of the HDZ.

2.10.2 Pension funds' lobby

Despite its fairly smooth organisation, mandatory pension funds did not engage in any major lobbying campaign involving its two main targets: the regulator Hanfa and the Ministry of Economy, Labour and Entrepreneurship for new legislation. One of the main reasons may be the institutionalisation of its role, as mandatory pension fund representatives are present in most working groups dealing with the issue. The final result is, however, that their most pressing demands are not being fully considered, because their demands were politically too sensitive. There was a discrepancy between the salience of the 3 mentioned issues (higher contributions, short accumulation and downside risk) and what was being discussed instead (investment limits, fee structure).

The attention of the media is focused on investment limits and the fee structure, however, these are probably minor problems burdening the Croatian second pillar and they are being slowly addressed. In fact, Hanfa is gradually reducing the compensation granted to mandatory pension funds for the elimination of the success fee by diminishing the management fee from 1.2% of the net asset value to 0.95%. In addition, the relaxation of investment limits (access to JDD, foreign markets, and derivatives, as well as higher single issuer limits) is slowly entering the agenda. The special law allowing for the allocation

of part of privatised INA shares to mandatory pension funds (Valentić, 2006) is opening precious political negotiation space.

Latković (interview) points to much more pressing problems, which need much greater political will to be successfully solved: a) low contribution rate; b) short accumulation period, especially for women; c) high downside risk. As can be readily seen, all three stem directly from past policy compromises, which take some time to generate negative side effects, but which are then extremely difficult to reverse.

As of April 2007, average monthly contributions to Croatian mandatory pension funds amounted to €31.2, which is a very low figure not capable of granting a reasonable compensation for falling net replacement rates in the public pillar. All pension fund managing companies are aware of the problem, a solution to which is still out of sight. The correlation with public pillar issues is here most visible: HDZ squandering of pension savings as well as more and more promises to 'new' pensioners unequivocally contradict the will to increase contributions to the second pillar, vaguely contained in the Strategic Framework for Development 2006-2013 (Vlada RH, 2006:48). In fact, each percentage increase would cost the government some €100 million, not a viable option under current circumstances (Matković, 2006a).

More or less the same holds for the accumulation period, especially of women. Thanks to successful opposition during the legislative phase, an equalisation of retirement ages at 65 was prevented. The problem is of course more complex, since Croatia faces a demographic catastrophe shared only by a dozen or so countries in the world, thus the idea of increasing the minimum pensionable age to 67 or 68 is being considered. An *a priori* opposition has already been voiced by most trade unions (Matković, 2006c).

With respect, instead, to the downside risk of these funds, the problem mainly lies in the high correlation of asset classes within their portfolios (Kotlikoff, 1999:19). Thus investment limits relaxation, allowing for greater risk diversification, is a move into the right direction.

2.10.3 Evolution of independent agencies and public administration lobby

The three institutions concerned – Regos, Hagena, HZMO – all underwent major restructuring since the implementation of the public pillar. However, only Regos, the most efficient and innovative, fell prey to bureaucratic capture by other, annexed agencies, such as HZZO, Fina and the Tax Administration.

Hagena was established as an independent agency rather instrumentally, in order to monitor the nascent pension fund market. Once the system started operating smoothly, the necessity for an integrated approach emerged, especially due to the overlap of supervision and regulation regarding investment and pension funds. Three agencies (Hagena, the Directorate for the Supervision of Insurance Companies and the Croatian Commission for Securities) had been merged by the beginning of 2006 into Hanfa, the Croatian Financial Services Supervisory Agency (OG, 140/05), which developed a functional internal separation of duties: risk assessment, licensing etc.

With respect to Regos, instead, agency capture can be plainly invoked. By September 2006, the very successful agency correctly assigned 99,42% of contributions to sec-

ond pillar individual accounts and its efficiency was at least partially responsible for a huge contribution collection coverage increase, thereby practically annulling transition costs for the 5% second pillar. Therefore, plans to create a single database for all payroll contributions and taxes were naturally assigning Regos a central role. This ambitious plan was, however, foiled by 2005 and Regos's existence is now threatened.

The two events are uncorrelated. Regos' database functions were relegated to first and second pillar contributions as of 2005 (OG 177/04) and the story is so far not public. The official explanation is the incompatibility between their datasets and those used by the Tax Administration (Bejaković, interview); however, a more plausible cause may be agency capture by the Tax Administration, HZMO and Fina which pressured the government – a relatively easy task with the HDZ – to maintain their own data collection functions, which, if lost, would have threatened hundreds of inefficient workplaces (Matković, interview). This loss of influence by Regos had a temporary negative effect on contribution collection, which slumped in 2005. However, preliminary data for 2006 showed a resumption of the positive trend towards increased compliance, which may indicate that individualisation rather than administrative efficiency chiefly underpins normative legitimisation of the new pension system (Anušić, interview).

With respect to future plans for Regos, the issue is still being debated. Regos is relatively expensive, costing HRK 100-120M per annum (although most of this money is paid for outsourced services performed by Fina), and it is financed through the general budget. It is imperative that part of these costs be borne by the insured who are ultimately benefiting from its services. However, there is no consensus on the practicalities and the options are either to merge Regos with Fina, privatise it or finance it entirely with pension contributions (Matković, 2006a).

3. Actors and institutions

3.1 Political parties

Not unexpectedly, the weaknesses of the Croatian party system are reflected in the involution that its pension schemes are undergoing since independence. As in other post-communist countries, the *élitisation* of Croatian politics widened, instead of bridging, the gap between civil society and political expression. Within this context, the electoral defeat of the SKH-SDP at the Croatian founding elections marked the emergence of HDZ's autocratic and populist style, which mixed clientelism and servility with extreme brutality.

As already mentioned, a delegitimated single-party system was replaced by a single-party nation-state, which drifted during the 1990s towards authoritarianism based on clientelistic favours and the almost perfect identification of the party with the state apparatus. Since HDZ, however, was not a communist successor party, the persistence of previous networks, which characterises countries where a '*ruptura pactada*' was negotiated, was in Croatia hardly automatic. Former elites were given the option to be co-opted or, alternatively, destroyed. Unsurprisingly, the corporatist arena - the specific way of organising industrial relations that includes all those actors (social partners) involved in social dialogue (employers, government, trade unions); as opposed to the political/electoral arena - was promptly wiped out.

Hence, the HDZ found itself in an ambiguous situation. On the one hand, it had ample leeway unilaterally to impose unpopular measures on the population, as for example with the Valentić decrees. On the other hand, it had continually to legitimise itself by granting favours to special interest groups, which managed to seize huge economic benefits, albeit in a very unstable environment. As Bićanić and Franičević (2003) correctly emphasise, the delegitimation of HDZ was at the end of the 1990s dual: Tuđman's party betrayed public expectations and it did not provide adequate guarantees to its cronies.

In any case, these peculiarities rendered the ambitious 1998-1999 pension reform possible, but they also transmitted various elements of uncertainty, which are slowly undermining the system's solidity. Radical moves, such as the creation of a German point-based public pillar, the obfuscation of the Actual Pension Value and the introduction of 'Croatian indexation' were accompanied with limitations to second pillar expansion, preservation of privileges and widespread exceptions.

Tuđman's death and the HDZ's deep crisis brought an end to Croatian 'demo-kratura'. The winning coalition the HSLS-SDP promised a thorough change in policymaking style, but is soon replicated some of the HDZ's negative traits and was therefore before long kicked out of office. The major achievement of the SDP era was a substantial improvement of relations with IFIs and the launch of Croatia's bid to join the EU. Domestically, performance was underwhelming and it chiefly hints at the systemic and endemic nature of Croatian clientelism, which prevents sound policies being implemented whenever a strong hands-tying arrangement is missing.

With respect to pension reforms, the emergence of the pensioners' party the HSU as a shameless single-issue formation contaminated the new reform concepts with old practice. HSU's boldness⁴⁸ was only matched by the incompetence of its leaders. Their dubious support for any coalition struggling for power (SDP in 2000 and HDZ in 2004), turned reform implementation into a farce and transformed the Croatian pension system into a cashbox from which to distribute political favours. Whereas supplements and increases characterised the SDP interlude, PM Sanader's government not only settled the pensioner debt issue, but is now, entirely for electoral purposes, trying to invert its own pension reform by solving the 'new' pensioners problem. In addition, Ivica Račan's premature death in April 2007 deprived the SDP of a credible candidate for the incoming electoral bout.

3.2 External actors

The World Bank played in Croatia a pivotal role in pushing for multipillar pension reforms. The influence of Croatian émigrés to Chile, the secondment of a Croatian World Bank official (Zoran Anušić) to the Plenipotentiary for pension reform and the absence of competing agencies, such as the EU (absent due to Croatia's negative political record), meant that the road for pension privatisation was paved. Right after the Homeland War, the economic situation recovered up until 1999, when the fiscal deficit spun out of control. During this period, however, relations with the Bank were rather problematic, as the HDZ refused to carry out some important economic and sector work (ESW) tasks such

⁴⁸ During local elections in May 2005, many HSU members got elected on centre-left election tickets only to support HDZ and right-wing parties during the forming of regional and municipal coalition governments.

as public expenditure reviews and a poverty assessment. The Bank rated the overall outcome of its assistance program as unsatisfactory until at least 2001.

Therefore, it is hardly plausible to talk of strong social conditionality on the Bank's behalf. In the Croatian case, an overwhelming information asymmetry probably played a greater role, since neither social partners nor academia managed to voice a consistent opposition to the government's plan. The absence of any alternative reform proposals and the failure to involve young generations in the pension reform debate are good proxies for this lack of knowledge and interest, as well as indicators of the still underdeveloped Croatian civil society.

3.3 Trade unions

Among the factors accounting for the decline of the Croatian corporatist arena the confrontational stance of HDZ during the 1990s emerges as key. However, structural features are also to blame. High unemployment, the informalisation of the economy, flexible work arrangements, as well as a very precarious financial situation are all responsible for the understaffing, atomisation and low bargaining power of the Croatian labour movement.

Croatian trade union confederations, headed by SSSH, were unprepared for pension reforms. They were at the same time busy with the implementation of the new Labour Code and they did not view pension reforms as something directly concerning their declining membership base. Thus, an important opportunity to voice their interests was missed, because of their rather inflexible interpretation of pensions as having negative distributional impacts on labour policies.

Ubi major minor cessat, as the problem of 'new' pensioners emerged in full, trade union confederations set aside their perennial disputes and compactly voiced their opposition to the 1999-introduced pension formula. Again, however, they probably could not see the wood for the trees, as continuous interference with pension details only augments the system's complexity and obscurity, instead of frontally tackling the vestiges of past privilege which survived since socialist times.

3.4 The Constitutional Court

As in many other Eastern European countries, the Constitutional Court of Croatia played a disproportionately important role (by Western standards) during the pension reform process. Insufficiently researched, this aspect of Hirschmann's voice has at least two causes in the Croatian case. First, the inaccessibility of government by civil society groups forces them to seek alternative routes to push for their interests. Second, the HDZ's authoritarian regression very much blurred the tripartition of power and the Constitutional Court wanted to reassert its independence in a radical fashion.

The final result was, however, doubly negative. On the one hand, the Court was downgraded in its role of guardian of the Constitution, as it asserted itself as a defender of popular interests and was lately flooded with cases on the most trivial matters. On the other hand, the damage inflicted by the recognition of the pensioner debt was not only fiscal, as an important part of budgetary savings have been squandered for consumption, but also moral, since interest groups (especially representatives of 'new' pensioners) feel entitled

to ask for compensation, which may in the end render reforms self-defeating as they progressively lose normative legitimization.

3.5 Financial actors and public sector agencies

Rather unexpectedly, financial actors did not influence the legislative phase of reforms. Two facts account for that: the triviality of asset management business in Croatia before the establishment of mandatory pension funds, which did not materialise in a coordinated lobbying effort, and the insulation of policymaking within the Plenipotentiary.

The situation, of course, radically changed after implementation started in early 2002. Four mandatory pension funds emerged after two years of competition and they organised themselves in an associated lobby at national and European levels. However, their efforts were not very successful, although collaboration with the regulatory agency Hanfa is satisfactory. Apart from some openings on the government's behalf, regarding the relaxation of investment restrictions, various issues are lingering at the margins of the agenda. The main problems are political and hence unlikely to be implemented, such as the increase in contribution rates for the funded pillar and an elongation of the contribution period, especially for women. The main cleavage within the association is represented by the juxtaposition of the two smaller and two larger funds. The automatic distribution mechanism of new entrants is at the centre of this dispute.

As regards the socialist inheritance, Croatia is burdened by an inefficient public administration, overlapping core functions of government and a cumbersome judiciary. One of the noblest attempts by the World Bank was to reorganise the revenue side of the budget as a corollary to reforms of the pension system. Regos, the Central Registry of Insured Persons, proved to be a very competent institution, which helped the smooth implementation of the funded pillar in Croatia and radically simplified employers' reporting duties. However, its wider objectives directly conflicted with the interests of employees in the Tax Administration, Fina and other specialised agencies. Although the full story is not yet public, rationalisation was cut short in 2005 within polemics on the low cost-effectiveness of the institution. Its fate is currently under debate.

4 Conclusions

The Croatian post-socialist pension system is probably the one which suffered the most from transition-induced overstretching. Between 1992 and 1996 employment fell by at least 25% in Croatia (429,753 fewer workers), while the number of pensioners increased from 691,021 in 1991 to more than a million a decade later.

In order to prevent costs from skyrocketing, PM Valentić implemented a radical stabilisation package in October 1993, which drastically limited indexation, thereby triggering the collapse of net replacement rates. Thus, once the Croatian economy started to recover, the pension system was completely delegitimated in the eyes of the public, as all major surveys show. On the one hand, its performance was abysmal as average pensions barely ensured subsistence. On the other hand, special privileges (early retirement rights, higher benefits for particular groups) were largely retained if not, in some cases, expanded. Basically, the system was deprived of defendants, thereby rendering a paradigmatic

ic change in favour of individualised private accounts a very palatable option. However, Croatian reforms were chiefly corrupted by their time inconsistency.

As has been shown in the preceding paragraphs, the Croatian pension system underwent major special interest group pressures, which both during the legislative and implementation phases weakened its long-term *political* sustainability. Croatian politicians, both from HDZ and SDP, did not heed the World Bank's primary recommendation, that is, *no more populism in the public pillar*. The Croatian example well shows the correlation between public and private pillar issues, meaning that political risk is never eliminated from the agenda.

The mechanisms that lead towards an institutional degeneration of the private pillar are related to both agency and structure. Giving in to interest group pressures not only deprived the government of important sources of revenues that could be used for the development of the funded pillar, but it also undermined the normative legitimization of the new system, as more groups feel entitled to demand greater compensation of losses. In addition, the socialist legacy put reforms on shaky legs, since transition costs limited the contribution rate to a mere 5%, the underdevelopment of financial markets prevented a satisfactory diversification of risk, and the insignificance of the Croatian capital market allowed for the successful operation of just four funds, leaving the system perennially exposed to oligopolistic threats.

As 2007, another electoral year, is advancing, the pension system is again becoming a major legitimising instrument in the hands of the incumbent HDZ. PM Sanader's party is once more trying to exploit the system for short-term electoral advantages, by promising to solve the 'new' pensioner issue. If there is a move, which may nullify all the efforts made so far, well, the wrong handling of this issue may well be it.

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