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Master Thesis

Contemporary Challenges of Public Pension Systems and Their Effects on Pension Reform Choices in European and Candidate countries

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LIST OF ABBREVIATIONS

EBRD – European Bank for Reconstruction and Development

EC – European Commission

EET – Exempt contributions, Exempt investment income and capital gains, Taxed benefits

EPC - Economic Policy Committee

ESF - European Social Fund

ESSPROS - European system of integrated social protection statistics

ETT – Exempt contributions, Taxed investment income and capital gains, taxed benefits

EU – European Union

FDB – funded system with defined benefits

FDC – funded system with defined contributions

GDP – gross domestic product

ILO – International Labour Organisation

IMF – International Monetary Fund

ISSA - International Social Security Association

MLSP – Ministry of Labour and Social Policy

MS – Member States

NDB – non-funded system with defined benefits

NDC – non-funded system with defined contributions

OECD – Organisation for Economic Cooperation and Development

OMC – Open Method of Cooperation

PAYG – pay as you go (pension system)

SPC - Social Policy Committee

TEE – Tax contributions, Exempt investments and capital gains and exempt benefits

Abstract

The process of European Integration and creation of the single market revealed many questions and boundaries on the development and improvement of the European Social Policy. Pension's sustainability has become the priority issue especially during the EU enlargement processes. Different policy instruments and institutions available to governments of Member States in realization of social objectives resulted in a growing diversity of pension polices which produced different combinations of public and private provisions - "private-public hybrids"[1], with the state exercising different degrees of influence in their development.

The objective of this essay has been to explore contemporary challenges of the pension systems in the EU countries and to analyse how these affect Member States in the choice for reform option. The question investigated for that purpose was whether there is a paramount policy response to the current surroundings of national pension systems and how by current and future reforms the European Union will build up the confidence in European citizens in the European Social Model and welfare countries?

The paper begins with an overview on the ageing of the population and demographic trends in the EU. This invoked the question: How should one relatively small group of employees to produce financial support for the rapidly increasing group of pensioners? Leading on from this, an analysis on the costs of retirement system was completed. Inability of national finances to cover the progressively increasing need of elderly, produced lack of confidence for European Citizens in pension systems and for Countries in Pension Funds. Numerous Pension Systems reforms initiated in Europe and some of them are already reassessing their primary policy options.

In order to prevent countries from expensive and extensive further reforms, the Commission's advise is to Modernise and create cross border pension systems. The Integrative and Method of Open Cooperation are elaborated as a proposal to Member States to use more quality indicators in projecting their pension system's sustainability, and cooperate combining their policy choices

[1] Noel Whiteside, "Adapting private pensions to public purposes: historical perspectives on the politics of reform", University of Warwick, UK

into integrated reports. Creating cross border pensions funds explores the importance of harmonising tax laws across Member states and elimination obstacles in investment of pension contributions.

Considering the importance of creating social peace in the process of European enlargement, in the last part the paper describes the example of the Macedonian pension's system reform under EU recommendations and learning from practices of the newly accessed CEE countries

Noting the relevance of policy formation, it can be said that progress in Harmonising and integrating national polices is visible. Cooperation among institutions governing reforms will provide: First, by obtaining quality data, system projections will improve and will make system characteristics transparent for beneficiaries (individuals can easily calculate their income/contributions at present and aggregate benefits for old age), which will secure European citizens from unpredictable government actions towards pension issues and strengthen their confidence in the national and European social policy. Second, by integrating national reports the European Union can easily determine patterns of reforms and evaluate best practices, which at the end will not provide one paramount policy option but will certainly facilitate future reform path in both member and candidate countries.

1. Introduction

Social policy has become a primary policy area of the European Union in the integration and enlargement processes. As the population in the EU is growing older, both old and new Member States are urged to ensure an adequate standard of living for a growing number of older people without overburdening the almost inferior working age groups[2]. Different policy instruments and institutions available to governments of Member States in realization of social objectives resulted in a growing diversity of pension polices which produced different combinations of public and private provisions, with the state exercising different degrees of influence in shaping salary-related pensions and their development.

The importance of policy choice in determining pension system's reform originates from financial requirements of the schemes. Since in most of the new accession countries in the pre-accession period, these systems were set on the pay-as-you-go basis, the debate to date has focused on whether "pay as you go" systems or funded systems will best meet the challenge of transferring goods and services from the active to the retired generations; and whether reform, should involve a reduction of Pay As You Go (PAYG) public provision in favour of private, funded schemes[3]. Irrespective of the method chosen, an expansion of the funding base is indispensable, through higher activity and employment rates for all of working age.

This paper is going to analyse the demographic crisis and fiscal effects of pension systems in European Union. The question investigated for that purpose is: whether there is a paramount policy response to the contemporary challenges of national pension systems and how by current and future reforms the European Union will build up the confidence in European citizens in the European Social Model and welfare countries?

[2] José Piñera "Will the pension time bomb sink the Euro?, *Cato Journal;* Spring 2004; 24, 1/2; ABI/INFORM Global pg. 45
[3]Noel Whiteside, "Adapting private pensions to public purposes: historical perspectives on the politics of reform", *University of Warwick, UK*

Leading from this point, given that sustainability of pensions is a central issue for the countries aspiring to European accession, candidate countries are in a place where numerous legislative adjustments and developments are needed in the search for the best reform approach. Therefore, the paper will describe the advantages and disadvantages of the public pension scheme currently in place (as the only old age support) through the example of the Macedonian pension's system reform.

Thus, sections 2 -4 will focus on the treatment of ageing society and sustainability of pension systems as major challenges of the pension systems in European Union. Questions rising in these sections point to: How should one relatively small group of employees to produce financial support for the rapidly increasing group of pensioners? What happens with saving when there is reform and substitution of public pay-as-you-go pension systems? Furthermore, having regard on different national retirement practices: Is it possible by enhancing the work skills and acquiring new ones to change the decision for pensioning? Section 5 and 6 elaborates the Commission Communications on overcoming the burden of ageing in the society by (1) Modernisation of the pension systems(integrated method and method of open cooperation) and (2) the need for Cross Border management and investment of Pensions. Section 7 explores the possible reform options and the matrix of pension schemes and finally Section 8 comprises EU recommendations into pension reforms in Macedonia, and possible reform options learning form practises of the new accession countries. Section 9 will conclude.

1.1 Delimitations

This paper as indicated above will discuss ageing as the main challenge of the Public Pension Systems in Europe and in the World. Therefore its implications will be considered mainly on the Labour supply and how affects National Finances seen through several country examples. Other aspects of ageing population: its effects seen through gender perspective, implication on health care systems and private insurance may be stated but with explanatory purpose not for the purpose of the essay. The title pointing to Candidate countries would be delivered through the case discussed in Section 8 for the Republic of Macedonia.

1.2 Methodology

The thesis is divided in 9sections. First 5 sections elaborate the problems of ageing and how that affected national finances elaborated through analysis of the current national reforms in the Europe. For the purpose of providing this essay with a global picture for the problem, the paper's focus is not on making a complete comparative analysis between couple of countries, but use International reports (mainly from OECD, World Bank and IMF) to prove the stated. Different Country specific reports will not be described as separate but combined through the specific working papers on the reforms in Europe and using a literature review. Section 7 will provide a framework of the possible reform options for the Pension Systems, which is used in Section 8 of the case study – The Macedonian Pension System Reform where empirical research is conducted for the advantages and disadvantages of two proposed options. Last part of the thesis draws a conclusion of the aforementioned parts.

2. Challenges of the Public Pension Systems in the European Union

The process of European Integration and creation of the internal market revealed many questions and boundaries for the development and improvement of the Social policy, which were not calculated when establishing the European Economic Community in 1957 (Rosamond, 2000). Even in the beginning the primary aim of "uniting people not coalitions of states" (Duchene, 1994) underlined the importance of the societal dimension of European integration. Furthermore its objectives were posted in Article 2 of the Treaty of establishing European Union where: "The Community shall have as its task ... to promote a high level of employment and of social protection…and the raising of the standard of living and quality of life..." and continuing in Article 3 with "the activities of the Community shall include ... the strengthening of economic and social cohesion;" the development of the integration process emphasized once again the importance of creating social welfare states in the European Union.

In achieving the responsibility towards its citizens, first part of the Social Agenda, the Social Action Programme initiated in 1998 until 2000. Regarding the social dimension of the Globalization, the Commission has highlighted that "Despite the successes of Europe's social model, poverty and social exclusion remain significant problems in the EU ... Public policies have a crucial role to play in helping to achieve this (an inclusive society) by...promoting income redistribution..."[4]

The agenda requires that societal actors within member states evaluate how the integration affected the individual/collective values and identities of citizens of the European Union. Along with Member States, the institutions of the EU reassess the future evolution of the Social Protection in terms of providing safe and sustainable pensions in Europe by using the benefits from cooperation with international organisations such as International Labour Organisation (ILO), Organisation for Economic Cooperation and Development (OECD), International Monetary Fund (IMF), World Bank and World Trade Organisation.

However, as the Commission initiated the social agenda 2000-2005, member states faced numerous problems in the performance of their public pension systems and in harmonisation among each other. Although national pension systems differ among countries by combinations of the multiple pillar system, problems that have occurred are quite common and need integrative strategy in order to combat obstacles.

“Pension systems comprise a complete set of arrangements for the provision of pensions; benefits in events of invalidity and survivors pensions, which contribute to the social protection of older people”[5]. They cover both public and private schemes and in the European region, they are presented by the multiple pillar system comprising basic public schemes, occupational schemes and individual pension plans[6]. Each of these, have widely differing roles for private retirement savings, government regulation and insurance on private savings, and government provision of old-age income support[7], and by that demonstrate specific advantages and

[4] European Commission, 2000, “ The Social Situation in the European Union” Directorate-General for Employment and Social Affairs Unit E.1
[5] Hantrais, L., 2000, “Social Policy in the European Union”, second edition.
[6] COM/2000/0622, Communication of the European Commission on the Future evolution of social protection from a long term point o f view: Safe and sustainable Pensions
[7] Mitchell, O. S. ,1993, “Retirement systems in developed and developing countries: institutional features, economic effects and lessons for economies in transition”, working paper No. 4424, National Bureau for economical research, Cambridge

weakness. Due to the immaturity of the newly transformed retirement systems in most of the EU10, the largest share of older people's income is still supplied through the public schemes.

In these circumstances the European Commission, the Parliament and the Economic and Social Committee put forward the common, interdependent challenges of transformation of public pension schemes in European countries and present most suitable actions that will accomplish the objectives of the European Social Policy at least in the mid-term[8].

Main challenges of public pension systems that will be examined in this paper are:

1. *The ageing society* as a major challenge on providing safe and sustainable pensions and therefore
2. *Financial unsustainability of public pension systems* as the inability of Member States to place public pension systems on a sound financial footing

Community actions towards these challenges are found in the:

1. Modernisation of both public and private pension systems in response to changing needs of the economy, society and individuals (flexibility and security on the labour market, tax systems and development of capital markets)
2. Cross border management of pension schemes - Mutual recognition of supervisory methods, by companies established in different Member States (tax coordination and harmonisation of control).

2.1 Is there a need for reforms?

Public pension systems have three main objectives: saving, redistribution and insurance. Most of the pension systems in EU25 were transforming from mainly public, unfunded schemes, (collecting contributions of the current employees and directly distributing them to the retirees or

[8] The future perspective of the European Union seen through the enlargement will further enhance the importance of the ageing population in creating the "European Family"

pay-as-you-go systems) to the multiple pillar systems (private pension savings and funded defined benefit schemes). This alteration will be examined by practices mainly in the new accession countries, and the combinations that solved the problems of fiscal burden and government's expenditures on pensions.

Public pension schemes not only concern the well-being of the elderly, but also the welfare of young labour force that directly or indirectly bear the expenses of securing old generations. By its simplest form the PAYG system (still attained by countries as the state pension system, first pillar) collect contributions of the active participants and use them to pay the benefits of the pensioner in the very year not questioning the possible inadequate redistribution as for example from poor cohorts to wealthy pensioners. Through years, the public systems required progressive financial resources to respond to the demographic changes in the world (the increase of the percentage of retirees) which in absence of reform, are realised through imposing higher payroll taxes, and this will deterrent productivity, and push labour force in other informal sectors[9].

Furthermore, this will have impact on national budget increasing the deficits and inflation, which will assist in ceasing public investment in infrastructure, education or health. Having regard to the fast reproduction of additional effects (the "invisible hand" in the economy) one can say that these systems have destructive nature to national economies.

Implications of the ageing population are extensive on employment, social protection, health and social services and demand a strategy for effective policy responses in these fields. As MacKellar[10] notes, the aging structure moves to the "middle" of the aging pyramid. Hence, starting from 2010 the massive *baby-boom* generation will grow old and retire on the labour market [11]. Thereto, working force rates on the labour market will not increase, but become negative around 2010, leaving relatively small group of supporters for the increasing number of pensioners. According European Commission's calculations[12], the role of the younger workers

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[9] OECD, 2005, "Ageing and Pension system Reform - Implications for Financial Markets and economic polices"
[10] Mackellar, 2000, " The dilemma of population ageing: A review essay", Population and Development review, Vol. 26, No.2, Landis
[11] OECD 1998, 2001, 2005
[12] European Commission , 1999, " Towards Europe of all ages- Promoting prosperity and Integration Solidarity, COM (1999)221 final, Office for official publications of the European Communities, Luxemburg, P.7-8

will significantly decline. Until 2015, the age group from 15 – 29 years will count around 16% of the total population. Starting from 2010 age group from 60-64 years will increase by 26%, 65-80 will attain 30 % and population 80+ years will acquire impressive 40% of the total population. This raises the question across Europe: How should one relatively small group of employees to produce financial support for the rapidly increasing group of pensioners?

Public pension systems already dealt these challenges by being partially (parametrically) reformed maintaining the balance on the pension systems which is not an answer in the long term, what so ever. Only a sustainable framework for policy responses towards ageing and preserving solid finances needs to be developed[13].

For evaluating propositions for policy responses of the European Commission on the challenges stated above, below I elaborate ageing and financial sustainability[14] of the public pension schemes.

3. The Demographic Context

The challenges to European societies caused by ageing are[15] *Pressure on retirement systems and public finances, demanding for further development of the formal health care systems (as there is a growing need for old age care), enhanced diversity in needs and wealth among older people* and i*ncreasingly importance on equal opportunities.*

Main features of the ageing population are (1) fall in fertility and (2) fall in mortality. According to United Nations projections and analysis, the world population in 2002 was estimated on a

[13] This framework was understood by many European countries as a reform call, so most of the newly accessed decreased the contributions in the public schemes and reallocates them to partly or fully capitalized schemes. Most of the reforms are on the base of best practices of switching strategies described by Góra and Palmer (1999) on the reforms in Poland and Latvia.

[14] The challenges of ageing and financial sustainability of the systems fro providing benefits of the elderly are often interdependent in Commission's communications. They are addressed as a consequential issues and activities undertaken by the EU deal with them as one problem.

[15] European Commission,1999, "Towards Europe of All Ages- promoting prosperity and Intergenerational solidarity", COM(1999)221, Brussels, Pg.2-7

number of 6,2 milliard with annual growth of 1,3%[16]. At present the yearly population growth rate is 1,3 %, and during the period from 2025-2030 it is anticipated to decline for almost half on 0,8%. Region with the lowest population growth is Europe, where projections for the same period is estimated on 0,1%.

The population of the European Union as of January 1st 1999 was roughly 375 million[17] and with the new accessions in 2004 is estimated around 456,8 million[18]. The number of babies born in the EU in 1998 descended to around 4 million. The fertility rate in the EU25 in 2004 was 1.50, with Ireland marking the highest rate of 1.99, and the Czech Republic the lowest 1.22[19].
Meanwhile, life expectancies have increased over the last 50 years by about 10 years in total. Due to the technological and medical improvements in the past century, average life expectancies amplified for minimum 3-7 years. In the period from 1990-1995[20], world average life expectancy was 65,9 years, while in the next five years have grown to 72,3 years. In Europe, life expectancies in this period was 74,8 years, and in OECD projections[21] it is expected to grow to 79,3.

3.1 Working age population

Social Security systems (public pension plans) have the imperative to secure high rates of employment for those of working age. The European Employment Strategy specified objectives towards unemployment in order “to bring about a significant increase in the employment rate of

[16] UN/ECE; 2002, “Economic survey of Europe: Demographic ageing and the reform of pension systems in the ECE region” No.3, “In this report according to numerous factors it is forecasted that until the second part of this century the number will be stabilized in around 9-10 milliard. More than 60 countries in world with lower fertility rates are counting for 2,6 milliard which is 44% of total population, but despite decrease in fertility rates the number will continue to grow as a result of already borne young generations”.
[17] European Commission,2000, “The Social Situation in the European Union” Directorate-General for Employment and Social Affairs Unit E.1
[18] Eurostat Yearbook, 2005, Europe in Figures, Panorama of the European Union , ISSN 1681-4789
[19] Eurostat Press Office http://epp.eurostat.cec.eu.int/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2006/PGE_CAT_PREREL_YEAR_2006_MONTH_03/3-06032006-EN-BP1.PDF
[20] OECD, 2001, “ Fiscal Implications of ageing: projections of age related spending”
[21] OECD, 2005, “Ageing and Pension system Reform - Implications for Financial Markets and economic polices”

Europe on a lasting basis."[22] Even in 1999, the EU stresses that low employment rate of older workers and invites Member States to develop measures that will: maintain capacities of older workers; encourage life-long learning and flexible working arrangements, as well as evaluate tax and benefit schemes to improve motivation of elderly to purchase jobs and training opportunities.

The past 20 years, with the entry of the baby-boom generations to the population of working age, produced a major increase especially in the 30-49 age group, therefore it is forecasted that the next 20 years will witness substantial changes in the contribution of various age groups[23]. However, at present countries still fill reports of numbers that show how minority active contributors continue to finance too many retirees in 20 years from now. These numbers call for urgent policy reassessments and permanent review of the situation.

3.2 Ageing process and labour supply

Retirement systems have great effect on retirement behaviour. Mitchell (1993) argues that the more generous the system, the earlier people retire and *vice versa*. Many studies from 1990s show that these generous systems, which were legislated in developed countries in the 1980, contributed to the lack of labour supply of older workers.[24] Still, not only generosity of the retirement benefits can be deemed for the decrease in the active workers among elderly but also mobility[25], productivity demanding jobs (health), technologically demanding jobs (computerisation) etc.

3.3 Adapting retirement ages to longer lives

[22] European Commission,1999, "Towards Europe of All Ages- promoting prosperity and Intergenerational solidarity", COM(1999)221, Brussels

[23] COM/1999/221, "…the 20-29 age group, who replenish the population of working age, will fall by 11 million … and the oldest group of 50-64 years will increase by 16.5 million, - more than 25%".

[24] Gustmann 1992, in Mitchell, O. S. ,1993, "Retirement systems in developed and developing countries: institutional features, economic effects and lessons for economies in transition", working paper No. 4424, National Bureau for economical research, Cambridge

[25] Speaking from a perspective of a developing country, public pension schemes (employer supplied) affect young working force in a sense that they deter mobility, requesting long years of serving before vesting.

The problem of early retirement in EU is distorting the labour market and need revising in every particular MS experience in order to establish clear picture of the pension system's impacts. Many MS use the retirement system as a source on the labour market: making easier for employers to support voluntary exit in order to provide place for young working force. Moreover, countries are concern - Is it reasonable, active workers to be retired 10 years earlier than their parents were? Is it possible by enhancing the work skills and acquiring new ones to change the decision for pensioning and the early retirement practice? How gradual retirement will affect the individual decision?

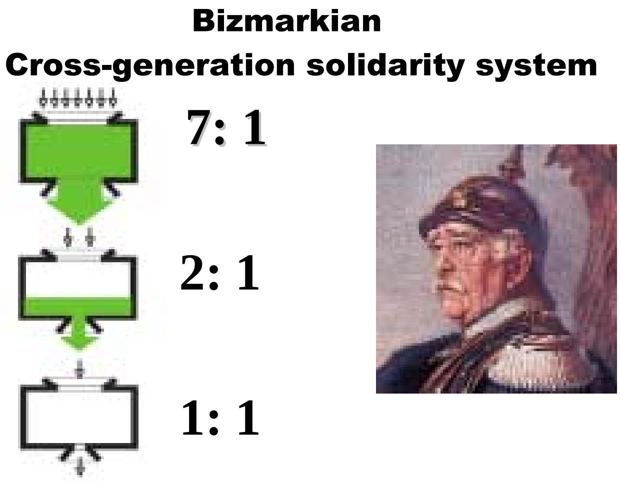
If we look at the approach of the Commission on these questions, it notes, "Our challenge lies in thinking outside the traditional parameters of a three stage lifecycle of education, employment and retirement. We need to be looking at innovative and imaginative ways of allowing people to work longer"[26]. Various polices have been undertaken on a national and on the EU level in order to reinforce the employability of ageing workers; adapt the workplace to ageing; and promoting equal opportunities. If this is so, what is the strategy for development of the Labour market? There are clearly adjustments in the human lifecycle perspective, by which the employment period urges to be prolonged which will (prolong the studying period) and limit possibilities for young jobseekers mainly because of the scarce labour demand. How is the Commission addressing young and active workforce, such as us, by these activities? In order to fulfil the gap in the labour supply and demand the EU supports Governments by granting the European Social Funds for increasing employability in its MS. Within the framework of the EU Employment Strategy, the Commission further supports the efforts of Member States for promoting active labour market policies to combat unemployment with particular importance on women's increasing participation of future labour force promoting equal opportunities between women and men

4. Financial Sustainability of Public Pension Systems

[26] Anna Diamantopoulou, Employment and Social Affairs European Commission, 4 February 2002, "Active Ageing in Europe" Conference on Extension of Working Life and Gradual and flexible Retirement Schemes Organised by the Spanish Presidency of the European Union Lanzarote

In many developed and developing countries Primary Public assistance presents "no more than a poor relief"[27]. It is generally restricted in funding and calculated as defined benefit plans. These formal schemes, which provided income for elderly, are dating since Bizmarkian system of social protection (Figure 1). In the second half of the 20 century, most of the western countries have adopted the system that covered most or all population.

Figure 1. Cross-generation solidarity system



Source: Wiener Stadtische, Allgemeine Versicherung Aktiengesellschaft, Working Plan

The system of cross generation solidarity, the PAYG system, had its fundaments on the demographic and labour characteristics in the countries in the 20th century. These were formulated in a system that provided seven active participants to cover the needs of one pensioner. Through years, these characteristic are changing which brought many of the European countries in the position where four active workers cover the needs of one pensioner[28]. Stimulated by the technological and medical improvements, actuarial projections in the CEE countries in the time of the reform of the pension systems show that trends will continue to decrease the number of the ones that are contributing to the system while the ones that expect pensions will double.[29]

Therefore, in order to provide solid and reliable finances, the three main functions of the system: Savings, Redistribution and Insurance call for revision and reassessment.

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[27] Hellner, J. and Nord, G., "Life insurance Law in International Perspective", Forsakringsjuridiska Foreningens Publikation Nr.20, Stockholm , 1969
[28] The European Commission and Economic Policy Committee Economic "report on the huge challenge to pension systems" published 14 February 2006
[29] OECD, 2005, "Ageing and Pension system Reform - Implications for Financial Markets and economic polices"

4.1 Savings

Savings are part of consolidating current income with future consumption. Thus, people give away part of their present income in order to be able to use it after retirement. Economists argue that people often underestimate the future, by not saving enough and are not able to have adequate income in future (retirement).

Knowing the fact that population is not disposed to saving for their future, retirement systems need to encourage or oblige individuals on compulsory savings.

What happens with saving when there is reform and substitution of public pay-as-you-go pension systems? Countries with generous PAYGO system have lower level of pension reserves. This implies to potential substitution, and many authors point to the impact of the reform on the increase in the private savings[30]. World Bank's research of the conditions under which capitalisation will have positive effects on private savings supports this. There are several reasons why people do not save enough. *First*, is that individuals show to be "short-sight". There are many reasons for this assumption: information asymmetries, health insecurity, income capacity, retirement expenses, financial stability of the savings instrument etc., which disables every attempt for rational decision whether and how to save. *Second*, pension insurance markets are object of well-known market inefficiencies. Insurance companies are vulnerable of so-called "reverse selection" issues. These are when insurance companies have less information of the life expectancies than the insured. *Third*, due to the undeveloped capital markets and insecure financial institutions, current market structures are not promising that they can provide appropriate financial savings instruments (World Bank, 1994). The last reason for people not willing to save for their future is the poverty that exists within nations especially in developing countries. (World Bank, 1994, p.38) Thus, passing from completely unfunded to capitalised financing will undoable increase the savings ratio.
Increased savings are a key source to enhance the financial foundation of the pension systems.

[30] Attanasio and Brugiavini, 2000, "Thinking about pension reforms: Discourses, politics, and public participation", International Social Security Association (**ISSA**), Helsinki

4.2 Redistribution

In cases where individuals do not save enough because of poverty, many economists have researched and pointed to the need for redistribution from wealthier to poorer as the main aim of the pension systems.

The necessity of redistribution rests on several factors: unemployment, invalidity and other family obligations (for women) which may prevent individuals from accumulating enough and secure income for retirement.

In order to fight poverty, World Bank (1999)[31] and European Commission (1999)[32] have pushed countries to perform progressive redistribution of incomes. This would mean progressive taxation from poorest cohorts to the wealthiest.

4.3 Insurance

Retirement planning includes decisions for future. However, many aspects of the future for individuals and societies are highly anxious and that means *risk*. Therefore the question is - What are the risks of aging?

According to the report o the World Bank in 1994, there are few risks to be mentioned:

- *Investment Risks;* pensioners or managers of their funds may convey irrational decisions about investing pension funds. This will reflect with decrease in the pension funds as opposed to the planned and quality investment decisions.
- *Invalidity Risks;* Retirement income is vulnerable on invalidity or sickness[33].
- *Aging Risk;* Pensioners may out-live their savings

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[31] Schwarz, M. A., Demirguc-Kunt, A., 1999; “Taking Stock of Pension Reforms Around the World”, World Bank
[32] COM (1999) 221 final, EC (1999) :”Towards Europe of all ages – promoting prosperity and intergenerational Solidarity”, Luxemburg, Office for official publications of the European Communities
[33] Hellner, J. and Nord, G., “Life insurance Law in International Perspective”, Forsakringsjuridiska Foreningens Publikation Nr.20, Stockholm , 1969

- *Political Risk; The* political frameworks in which individuals acquire pensions and savings may change. Worst case will be complete collapse of the governmental efforts (such as in some republics in former Soviet Union for example Ukraine)[34]
- *Risk of Insolvency;* According to ILO (1999) this risk includes collapse in the public administration of pension funds;
- *Inflation Risk;* Pensions are not secured from price fluctuations. In this case real purchasing power of pensioners may decrease;

These risks need to be taken care of in order to perform a sustainable pension system reform. Moreover, it provides countries that follow the European model of social security to answer How social is their Social policy?[35]

4.4 Awareness of challenges

Contemporary societal changes call for response from Member States to prepare for the impact of ageing on their public pension systems. Having to understand the extremely unpredictable variable, especially by promoting enlargement of "European family", requirement for change in the attitudes towards ageing and finances is a step towards maturity of National Policy makers. Hence, the Commission calls for integrated approach[36] and open method of cooperation[37] and implies that "…while each member state is responsible for its own pension system, the sustainability of these will determine the European Union's capacity to promote a high level of social protection, which is one of the main objectives of the Treaty establishing European Union".

Permanent advocating on reinforcement of the element of solidarity in order to avoid social exclusion and that the large growth of the share of pensioners will require increase in the resources detracted by the active population show that the EC is aware of the challenges and

[34] Daykin, C., 2002, "Risk Management and Regulation on defined contribution pension schemes", ISSA, Moscow
[35] Horst Feldmann, "How Social is European social policy?" International Journal of Social Economics, Bradford, 2002. Vol.29, Iss.7/8; pg.547, 28 pgs
[36] Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee – Supporting national strategies for safe and sustainable pensions through an integrated approach/ COM/2001/0362 final
[37] Joint Social Policy Committee (SPC) and Economic Policy Committee (EPC) report of November 2001 on Objectives and working methods in the area of pensions : applying to open method of coordination

ready to help MS to fight their inner policy inefficiencies. Awareness of the replication of the pension reform to other sectors in the economy as the labour market and capital market is crucial.

4.4.1 Labour Market Characteristics and Social Security

The awareness of the changing needs and characteristics of the Labour Market in the European Union came especially important with the enlargement. Older population is increasing rapidly and in the same time, the share of the young active workforce is escalating. In the current surrounding, as previously mentioned, there is equally important to worry about pensioners as much as the young jobseekers. Providing space on the labour market for all that need jobs is the essence of maintaining the public pension systems. The target of full employment and greater social cohesion is underlined in the Lisbon Strategy initiated in 2000, which seeks to make the EU "the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion".

As noted in the assessment of the ageing challenge, the focus has moved to reforming the labour markets, perceived as an instrument for achieving the “social protection” goals. The European Employment Strategy sets the three key, interrelated objectives as following[38]:

1. Working towards full employment;
2. Quality and productivity at work;
3. and social cohesion and an inclusive labour market

4.4.1.1 Full Employment

To achieve the Lisbon target 20 million more jobs need to be created in the EU- 25 by 2010[39]. On the first review of the European Employment Strategy in 2003 goals were evaluated: The

[38] These strategies are supported by the European Social Fund, especially in the process of EU enlargement; the new accession countries receive target funds (as we will se in the section for the Republic of Macedonia) as to increase employability, promoting vocational training and special working arrangements.
[39] Communication from the Commission to the Council , The European parliament, The Economic and Social Committee and the Committee of the Regions; COM(2000) 379 final; Social Policy Agenda, Brussels 28.06.2000;

overall employment rate targeted on 70 % by 2010, created over 12 million new jobs between 1997 and 2002, 60 % for women (it was 55.5 % in 2002) and 50% for older workers – aged between 55 and 64 (it was 39.8 % in 2002)[40]. The emphasis was again on helping the long-term unemployed and older workers return to or remain on the labour market reduce unemployment and enhance productivity, as well as integrating immigrants into the labour market.

4.4.1.2 Labour market distortions

Considering the alignment of contributions and pension benefits, market disturbances[41] including redistribution inefficiencies and inflation effects need to be assessed and provide conditions for purchasing the right for pension benefits. These goals are easily achievable if targeted pension benefit levels and the level of payroll taxes are established. Thus, increase in the payroll taxes in the public pension schemes will only shift the employment in the informal sector, distort the labour market and support tax evasion. However, reforming the public pension schemes would force contributions to split in more than one pillar and therefore lessen the burden of employee’s compulsory contribution to the pension system, which on the other hand means that the number of contributors would have to increase in order to maintain solid financial foundation of the retirement systems.

4.4.2 The effects of the Public pension System’s reforms on the Financial and Capital Markets

Although there is a direct link between reforms in the public social security system, enlarging of institutional investors and capital market development, it should born in mind that the primary goal of the reform is not development of financial markets but maintaining and improving the sustainability of the systems in order to attain adequate pensions. This implies to the structure of the pension systems and performance of the annuity markets[42].

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[40] Mary Brazier, Communication Unit, DG Employment; European Commission “The European Employment Strategy: more and better jobs” of 19 June 2003

[41] These are often presented by perceiving the contributions as a form of taxes, and not savings for obtaining pension benefits. In these circumstances Labour demand decreases and informal sector develops.

[42] OECD 2005

Nevertheless, the question arises: Is it possible to carry out a reform in the absence of a well-developed capital market? Seen through a prospective of a transition economy[43], the switching to a funded pension plans in the absence of developed capital and financial market will be unsuccessful, since these contributions will be used as a source of financing budget deficits.

There are several prerequisites for the development of the financial sector in order for the public pension reform to be implemented.

1. Macroeconomic stability – seen through maintaining low and stable inflation
2. Stability of the fiscal system –budgetary deficits enlarge in the process of reforming the pension systems[44]
3. Efficient Financial Institutions –developed Banking and Insurance sector
4. Creation of Effective Regulatory and supervisory agencies

Reforms that include transformation of public pension schemes have strong effects on the development of the financial markets. These can be best described by the common functions of the financial systems such as regulation of payments, applying mechanisms for investment of the funds ensuring diversification, transferring the resources of the economy, managing anxiousness and risk control, providing information transparency etc.

Pension funds (presented by the multiple pillar system) offer a computation of methods under which contributions are accumulated in order to provide pension benefits[45]. In other words, Pension Funds act as institutional investors managing with these resources on the financial market.

One of the reform advantages, towards funded pension plans is international portfolio investment and diversification of the risk. However, capital mobility (outflow) can be sometimes unwelcome, perceived as a loss of the potential for development of the domestic financial

[43] A detail analyse on the importance of the capital markets in the Transition economies is presented in a report on "Pension Funds and Capital Market in the Republic of Macedonia" by Klaus S. Hebbel, 2003

[44] Kai A. Konrad.and Gert G. Wagner, "Reform of the public pension system in Germany", 2002

[45] Ibid

markets. Most of the Central Eastern European Countries, prior to accession, were transition economies with not well-developed financial market. For these countries, capital outflows were seen as trouncing the economy and in some were robustly regulated[46]. Even so, in terms of pension system improvement, it is a common belief that enhanced capital mobility is of outmost use in decreasing the flux of the benefits.

Despite the quantitative effects, reform of public pension funds has an effect on the qualitative development of the financial markets[47]. This kind of improvement eases the main functions such as managing the risks and obtaining price information.

Introducing and implementing funded pension system have even greater qualitative influence on the corporative sector[48] and especially on corporative management[49].

4.5 Costs of public retirement systems – EC, OECD and ILO on the need for reform

"The 'Pensions' figure comprises part of periodic cash benefits under the disability, old-age, survivors and unemployment functions. It is defined as the summation of the following social benefits: disability pension, early-retirement due to reduced capacity to work, old-age pension, partial pension, survivors' pension, early-retirement benefit for labour market reasons"[50]. According to the reports of the International Labour Organization 1999, pension expenses in

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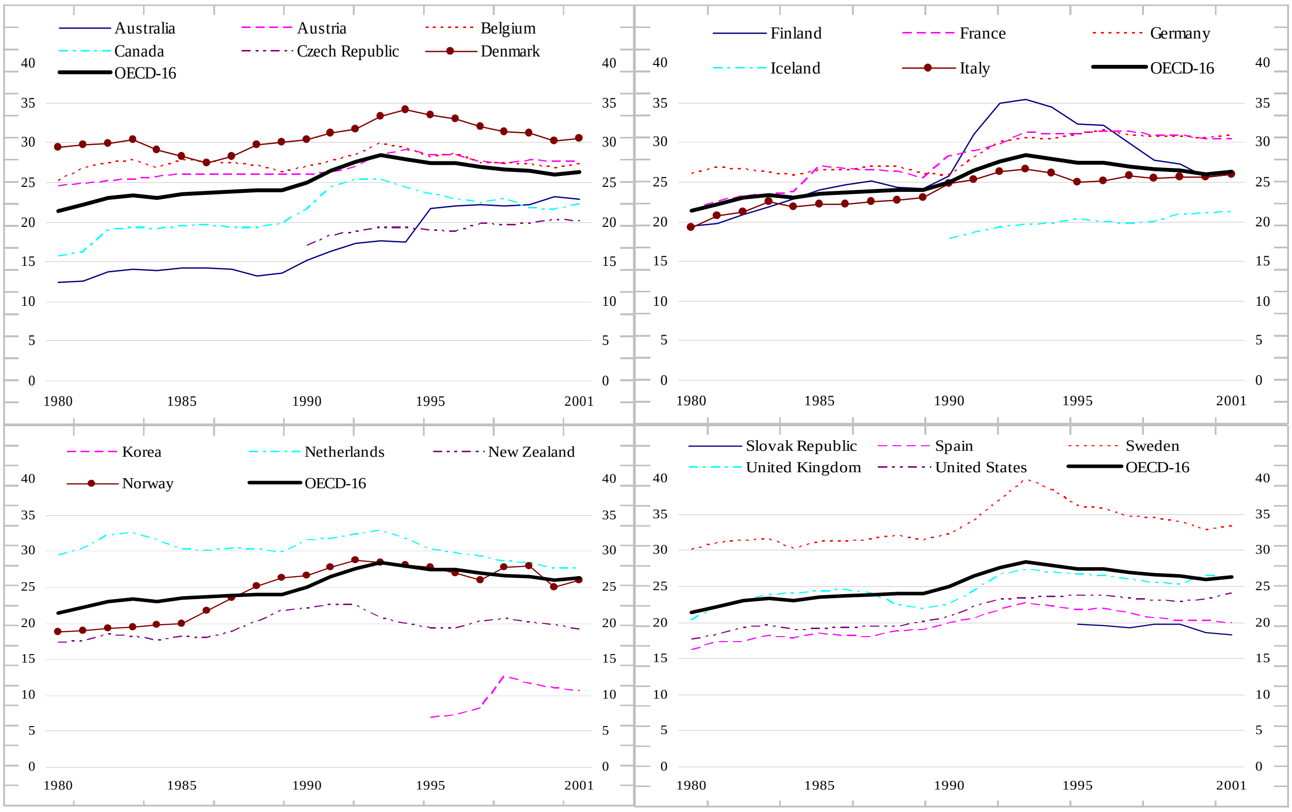
[46] Palacios, RJ. And Rocha, R., 1998, "The Hungarian pension system transition", Social Protection discussion paper no. 9805, World bank
Gora, M. and Rutkowski, M., 1998, " The quest for Social Security Reform: Poland's Security through diversity", Social protection discussion paper no.9815
Schwarz, A. , 2004, "Slovak Republic: Pension Policy Reform", Human Development Unit, Europe and Central Asia Region, World Bank.
[47] Vladimir Filipovski, "Capital Market and development of financial sector in the process of economic transition", Skopje, 2003; "Pension funds support and promote development of financial innovations. They directly or indirectly support the improvement of "asset-backed" financial instruments, mortgage markets and corporate bonds".
[48] Switching to funded pension systems will provide potential for development especially for small and medium sized enterprises (SMEs)by decreasing the financial risk in case of recession (Filipovski 2003)
[49] Family-run corporations that apply for founding capital on the market may be forced to decrease their share in the management, which will impose new potential route for transition of the structure of corporate management. (Filipovski 2003)
[50] COM (1999) 221 final, EC (1999) :"Towards Europe of all ages – promoting prosperity and intergenerational Solidarity", Luxemburg, Office for official publications of the European Communities

high-industrialized societies are the highest provision in their Public Budget acquiring in average 9% of GDP[51]. In early 1990, in many Eastern countries these costs were over 10 % of GDP, which created the biggest national expenditure. Public pension costs comprise all expenses for ageing pensions, costs for early retirement that are integrative part of the public pension system, family pensions and minimum guarantee pensions. According to 2001 OECD, report pension expenditures gain more than 7.5% of GDP in developed countries. Differences are found in variations of the characteristics in Retirement programmes, systems maturity and the rate of public funding across countries. Numerous developed countries such as Austria, Belgium, France, Germany, Italy, Poland, Spain and Sweden have higher expenses than the average, due to the aging of retirees.

Figure 2 Public Pensions expenditure as a percentage of GDP 1980-2001



Source: OECD, Net Social Expenditure, 2005 Edition,

[51] International Labour Office, "The development and reform of social security pensions: The approach of ILO", Executive summary, Geneva, 1999

4.5.1 Trends in public pension expenditures

According to OECD projections based on unchanged policy and not implemented reforms in the retirement systems numbers show that pension costs will rise in average of 3-4%of GDP in the period until 2050 (with variations across countries).

Projections show that the level of pension expenditures will decrease in Poland and Italy as a result of introducing the third pillar - Private Retirement Arrangements, however due to the previous reform Italian government expenditures in the field of pensions will maintain on the same level[52]. Despite that, in most of the countries there is an increasing trend in pension expenditures of 3-4%, especially during this decade until 2030 and stabilizing in the period of 2035-2050[53].

Table 1. Public Pension Expenditure, 1980-2050, Selected Countries

	Actual		Projected	
	Δ1980- 1993	Δ1993-2010	Δ2010-2030	Δ2030-2050
Australia	-0.1	-0.3	0.5	0.7
Austria	1.4	1.4	4.2	0.5
Denmark	0.8	0.8	3.3	0.6
Finland	4	0.6	7.1	-0.1
France	2	-0.9	3.8	0.9
Germany	-0.3	0.7	4.7	1
Ireland	-0.3	-0.1	0.2	0.2
Italy	3.6	1.4	0.8	-1.6
Netherlands	0.7	0.1	5.1	0.2
Norway	1.5	0.8	4.9	0.6
Sweden	2.1	0.6	2.6	-0.5
UK	0.8	0.7	0.3	-1.4

Source: OECD Ageing Working Papers, AWP3.4

Difference in the cost impact in country's GDP in the period 2000-2050 can be illustrated through several effects:

[52] Franco, Daniele, 2002 "Italy: A never ending Pension Reform", SP discussion Paper No. 9815, World Bank Pension Reform Primer, Washington, DC
[53] OECD, Economic Outlook: Fiscal Implications of ageing – projections pf age-related spending, 2001

- The effect and dependence on the aging population, showing variation in the population over 55 years old, and of age 20-64;
- The employment effect which comes from the change in the percent of working population between 20 and 64 years;
- The effect of benefit provisions, in line with the changes in the average pensions per employee as a percent of GDP;
- Effects of retirement qualification, regarding the change in the percentage of the employees over 55 in the ones qualified for retirement

Results show that there is increase in the costs due to all of these components, and that the biggest impact is still on the aging population of over 5% of GDP[54] (countries experiencing this effect are Austria, Czech Republic, France, Germany, Italy, Poland, Portugal and Spain). However, in many countries there is a trend in the increase of the employment, which declines the costs of pension systems especially due to enhanced participation of women in the working population, lower unemployment and advanced average age of retirement.

Contrarily, projections imply to the positive relation between average pensions and productivity, which has positive effects on the pension costs for over 1,5 % of GDP. This is due to many factors: (1) shifting indexation of pensions from wages to prices (Finland, France, Hungary, Italy, and Japan)or from gross to net wages as in Germany; (2) expanding the period of contribution in the retirement system (France); and (3) enlarging the period of pension calculations such as in Czech Republic, Belgium, Finland, Italy and Spain[55].

The trends in decrease of the pension provisions are noticed in many countries. In Italy, reforms include a system where provisions are due to contributions, indexed on prices and actuarial adjusted to the increase in the age expectancies. This will decrease the benefit provisions for 5-6% of GDP[56]. Similarly, reforms in Sweden will contribute to lowering benefit provisions[57].

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[54] OECD, 2005, “Ageing and Pension system Reform - Implications for Financial Markets and economic polices”

[55] Holzmann, R., “Pension reform, financial market development and economic growth, preliminary evidence form Chile”, IMF, 44/2, 1997

[56] Franco, Daniele, 2002 “Italy: A never ending Pension Reform”, SP discussion Paper No. 9815, World Bank Pension Reform Primer, Washington, DC

Rapid decline of the provisions in Japan are due to the legislative, which implies adjustment of pensions on a 5-year basis, in order to maintain stable pension system. Consequently, these reforms in policies will lead to gradually declining in the pension provisions in future and in some countries decrease more than 20 %[58]. Lower income and increasing poverty among elderly represent the risk of political pressure and move these policies in other direction. This underlines the need for creating new conditions to support private saving for retirement.

Future Financial development of the public pension systems in the European Union is elaborated in a World Bank survey of 2003[59]. The results on the costs projections revealed by the World Bank are just about the ones gained by the European Social Protection Committee, the Economic Policy Committee[60] and the European Commission[61].

According to the Economic Policy Committee, pension costs in the European countries will rise of approximately 3,9% of GDP in the period 2000 - 2050[62], while European Commission is calculating much higher impact on these costs putting them on 7,1% of GDP. This calculation is due to Commission's comprehensive methods having regard on the generosity of pension systems and their impact on the labour market.

All these studies point to the immense impact of Pension systems and their reforms on the European and world economy. *First,* the load of aging population enforce countries to react fast in determining reforms which will be most appropriate; that will strengthen and maintain their fiscal consistency. *Second,* strengthening funded pension arrangements is changing the structure of the risks and imply to the need to adapt to a new regulatory framework (coordination). *Third,* they influence the function of the capital markets and monetary policy.

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57 Kruse, A. and Palmer, E. "The New Swedish Pension System- Financial Stability and the Central Government budget", Paper to be presented at the Urban Institute's International Conference on Social Security Reform, 24 February 2006

58 Mitchell, O. S. ,1993, "Retirement systems in developed and developing countries: institutional features, economic effects and lessons for economies in transition", working paper No. 4424, National Bureau for economical research, Cambridge

59 By P.C. Rother, M.Catenaro, G. Shwab,

60 Joint report OF THE Social Protection Committee and Economic policy Committee on the objectives and working methods in the areas of pensions14098/01

61 COM (1999)221

62 OECD survey has given results of 3,8% increase in pension costs, and World Bank forecasts 4,2%

5. Commissions approach on the Ageing and financial sustainability as a major challenges on the public pension systems

Modifications in the age structure in the European Union showed that policy creators have to increase coordination and adjust public management in pension reforms. Although the path of reform will differ in each particular Member State because of different socio economic and cultural circumstances, the EU interprets ample regulations for reforms. Policy creators has to include the ageing influences on the health expenses, economic growth and overall on the social Integration.

First, retirement system reforms must secure consistent and adequate base for benefits of the public pension schemes. *Second,* the systems must present sustainable combination of pension pillars based on the legislation (collective or bilateral conventions or private arrangements)[63].*Third,* retirement systems must maintain the balance between long-term sustainability, intergenerational solidarity and equality between and inside generations.

The European Union notes that reforms should cover three sets of rules[64]:

1) Strict prudential rules to protect beneficiaries, by providing sufficient information on the rules of pension schemes and on the institutional financial situation

2) Investment rules, promoting efficient management of savings, diversifying assets by taking full advantage of the benefits offered by the single market and the euro

3) Rules permitting Cross-border management of pension schemes, which requires mutual recognition of companies established in different MS and supervisory methods used on national levels as well as appropriate tax coordination among MS

As I already mentioned in several occasions, problems that occur in the transformation of the public pension schemes are complementary and they start with ageing. Main impact of ageing population is on the influence on the labour market. The importance of ageing in the labour market in the EU comes from the importance of creating the internal market for pension

[63] European Commission , 1999, " Towards Europe of all ages- Promoting prosperity and Integration Solidarity, COM (1999)221 final, Office for official publications of the European Communities, Luxemburg, P. 15

[64] Pension Funds Directive 2003/41/EC

schemes. According to commission's findings, labour market and pensions contributions depend solely on the active representatives of the older employees. In order to maintain successful economic growth, MS will have to use their unexploited employee's capacities. This implies to decrease in the high European rates of unemployment, as well as reintegrating older employees in the working force. The Commission notes that obstacles do not occur in the behaviour of the older employees, but in the socio-institutional experiences toward them.

Concentrating efforts solely on reforms on the retirement systems would not be enough to defeat challenges of ageing population. "Although pension reform is important element in the overall ageing strategy, still it is a lasting and tough process"[65]. What is more important is that no mater what kind of system is accepted, transfers from young to elderly will increase. Lowering the burden does not mean switching to funded systems, on the contrary, this means widening the capital base in every aspect: including older employees, unemployed and women.

Thus, public pension reforms present important part of the adjustments on ageing population, and will be effective only if there is active ageing and increase in the employment rates. Active ageing, is the process of forcing employees to work longer by creating flexible arrangements on the labour markets for exceptional retiring such as special training for acquiring additional skills for the older employees and creating partial working hours. Lifelong learning is regarded as a core element for reaching the Lisbon goal of becoming the most competitive and dynamic knowledge-based economy in the world. This will help individuals to update and complement their knowledge, competencies and skills, thus contributing positively to reinforce their position in the labour market.

5.1 The perspective of solutions - Is it enough?

Is there a degree of inconsistency in European polices in the new common objectives in the area of pensions? As regarding to the major challenge- ageing population, which is the base for other effects on the labour and capital markets, the Commission constantly advocate on "Adequacy of

[65] European Commission,1994 " Supplementary pensions in the EU", report by the EU network of experts on supplementary pension provision, Social Europe, Supplement, No.3/94

pensions". This is accurate as to maintain the capacity of the system to reach the social objectives in the Agenda until 2010[66]. "To ensure that older people are not placed at risk of poverty and can enjoy a decent standard of living … provide access for all individuals to appropriate pension arrangements… and to promote solidarity within and between generations." In my point of view, the first round reforms, transformation to the multiple pillar pension systems in CEE has witnessed that new systems only lowered the benefits of older workers and helped governments to safeguard national budgets and transfer the load on the employees. The reform of the public pension system focuses on controlling the growth of the public expenditure, while other two pillars play greater role in the improvement of the income provision for older people. These reforms, objectives, working methods and approaches show perfection when thinking about young workers and students, as in the case. Yet, as an answer of the ageing problem, seems more than superficial to me. The imposition of higher payroll taxes on young working force, in order to provide solid finances for the elderly, would just encourage them to be engaged in the informal sector and still obtain pension provision provided by the private saving.

On the other side by promoting active aged workforce, the Commission implies that Member States should reconsider the age of retirement and try to attain older people in the active working force, which with the present labour market demand means that there will be less space for younger jobseekers to purchase the employment they need. Thus, the real problem should be analysed in socio-institutional experiences and practises in order to find which systems marginalize workers and which support them by means of immigration and development of the internal labour market.

6. Challenges Response

6.1. Modernisation of public pension systems

Intrigued by the societal changes in the EU and in the world, modernisation of the public pension schemes come as a solution on the main problems raised by ageing and inability of national

[66] Communication from the Commission on the Social Agenda /* COM/2005/0033 final, "A social Europe in the global economy: jobs and opportunities for all"

fiscal systems to bear the load of pensions. The Lisbon European Council of March 2000 gave stimulus to a method of policy exchange among the Member States of the EU on the modernisation of social protection systems. Although, each Member State is responsible for performing national reforms considering their social environment, the aim of the European Union is to modernise national systems by making *alignment between national polices* and the changing needs of the economy, society and individuals in the EU. In search for a solution on the ageing problem and sustainability of public pension systems, the Union calls for consolidation of the reforms: “modernising and improving social protection, promoting social inclusion, strengthening gender equality and reinforcing fundamental rights and combating discrimination”[67].

Therefore, “A concerted strategy for modernising social protection”[68] initiated in 1999 as a result of four priority issues:

- To make work pay and provide secure income - Modernising Social Protection for More and Better Jobs[69]
- To make pension systems sustainable[70]
- To promote social inclusion[71]
- To ensure high quality and sustainable health care[72]

The strategy is highly focused on flexibility and security on the labour market and tax systems. It proposes a variety of incentives, which can “support workability, make work pay and ensure a high level of social protection for all, while, at the same time, avoiding excessive budgetary costs”[73].

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[67] COM/2000/379 final
[68] COM/1999/347 final of July 1999
[69] COM/2003/ 842 final
[70] COM /2000/622 final
[71] Communication from the Commission of 27 January 2005 - Joint Report on Social Protection and Social Inclusion, COM(2005) 14 final
[72] Communication from the Commission of 20 April 2004 - Modernising social protection for the development of high-quality, accessible and sustainable health care and long-term care: support for the national strategies using the "open method of coordination" COM(2004) 304 final
[73] Communication from the Commission on the Social Agenda /* COM/2005/0033 final, "A social Europe in the global economy: jobs and opportunities for all”

The European Union's approach on these issues has always been with ample awareness on the present labour market characteristics. High overall unemployment; a high share of young, female and long-term unemployed, changing household patterns and the emergence of new working arrangements. By these initiatives, the Commission force employability and adaptability with the goal to create strong incentives to work and to make work pay in order to safeguard old age income.

Most important issues in modernisation pension systems are *tax systems* – they must make work more beneficial for jobseekers and the "need for social protection systems to provide the necessary income bridge and the active help necessary to prevent a temporary gap between jobs from sliding into long-term unemployment"[74].

In order to combat the challenges of the ageing population, and to support national pension reforms as a way to safeguard the European social model, economic growth and stability in the European Union the Commission has communicated the Integrated Approach and the method of Open Cooperation for the national strategies towards safe and sustainable pensions.

6.1.1 Integrated European approach towards safe and sustainable pensions

The main idea for creating a framework for sustainable pensions comes from the need to safeguard capacity of pension systems, to ensure financial sustainability and to improve the systems to respond to the changing needs of the society. The enlargement process certainly fuelled the changing needs of European society. The new 10 accession countries in 2004 have enormously increased the number of working and aged population in the European Union, and will enhance with current candidate countries. Labour market characteristics altered and national pension and insurance polices have been reassessed and put under reform[75]. Yet the need of harmonisation of laws among each other is a procedure.

[74] Lisbon Council 2000
[75] Dieter Bräuninger, 2002 "Pension reforms in the large accession countries", EurActiv

The integrated approach proposed by the European Union focuses on principles that will simplify the achievement of the common objectives and will secure the future of pension systems[76].These are:

1. In order to obtain adequacy of pensions, MS should use a combination of different pillars and provide access for all individuals to appropriate pension arrangements necessary to maintain the desired living standard after retirement.

2. Adequate pensions is only possible if financing is available, consequently MS should raise employment participation or increase total employment by supporting immigration. As a part of such efforts, “pension systems and their interaction with the tax-benefit system should be reviewed with regard to the incentives they offer for high labour force participation” so they will not encourage early retirement. Moreover, in order to diminish the budgetary impact of the ageing population, governments should ensure that public spending on pension is maintained at the appropriate (lowest) level of GDP[77]. Measures for equal distribution should include adjustments in the level of pensions paid to the retired and contributions/taxes levied on the active population.

3. Pension system reflects changes in the society and the labour market. Main principle in Modernisation of pension systems is to eliminate discrimination based on sex while addressing the sources of gender related inequalities in pension entitlements. Systems should be more transparent, to provide reliable and easy understandable information of the long term prospective and provide methodological basis for monitoring pension reforms and polices.

In the communication for integrated approach, the Commission calls for evaluating common appropriate indicators[78]: of the *performance* (eurostat and international organisations), *policy* indicators (national institutional information) and *projections* (retrospective indicators). These

[76] Communication form the Commission to the Council, the European Parliament and the Economic and Social Committee – Supporting National strategies for safe and sustainable pensions through an integrated approach COM/2001/0362 final
[77] The Commission states that the pension costs as a percentage of the GDP, in each of the MS should be compatible with the Growth and Stability Pact.
[78] The Commission Communication (2003) 261 of May 2003 entitled "Strengthening the social dimension of the Lisbon strategy: Streamlining open coordination in the field of social protection" includes a statement on the need for indicators

indicators would cover main three polices that contribute the future development of pension systems: Employment, Public Finances and Social Protection[79].

Obtaining the available indicators, social and financial sustainability will be acquired by:
Mutually reinforcing polices and ensuring coordination between relevant actors in the integration process

1 Mutually reinforcing polices

In order to deal with mentioned challenges the Commission introduces the concept of "triangle" of mutually reinforcing policies - employment, social protection, and economic and budgetary policy[80]. Thus, structural reforms of the employment policy (labour market) should include effective work incentives in social protection and pension systems and improve the long-term perspectives regardless of the schemes under which pensions are funded. Consequently, this would support sustainable economic growth[81], by facilitating reforms in consolidation of social and financial objectives, and finally, Social protection would ensure adequate level of income for pensioners supporting the goal of an active welfare. “Only a strong positive interaction between employment, social protection, and economic and budgetary policy, can guarantee the future ability of pension systems to fulfil their basic social goals.”[82]

2. Ensuring coordination between relevant actors in the process

The second suggestion from the Commission to the MS is for them to ensure that these polices are coherent, complementary and integrated. In order for MS to apply national polices that can ensure sustainability of pension systems, contributions that come from various policy making

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[79] “Integrated policy strategies are required that cut across many policy areas, including for example: social protection, employment, immigration, organisation of work and industrial relations, public finance, prudential regulation, life-long learning, equal opportunities and social inclusion.” COM/2001/0362
[80] As outlined in the European Social Agenda adopted at the Nice summit of December 2000
[81] The economic efficiency and pension schemes is described in detail by Góra and Palmer (2004) “Shifting perspectives in Pensions”, Institute for the Study of Labour, discussion paper No.1369. By using a mixture of possible pension schemes, the burden for future generations will decrease and by that, the fear of destabilising public finance that might jeopardise macroeconomic stability will evaporate.
[82] Franco, Daniele, 2002 “Italy: A never ending Pension Reform”, SP discussion Paper No. 9815, World Bank Pension Reform Primer, Washington, DC

processes must be distributed and coordinated among the policy makers both at national and at European level. Therefore the Union proposes that each MS including countries candidates to set out their strategies for ensuring the sustainability of adequate pension provision and modernising their pension systems in integrated national strategy reports.[83][84] “These should explain the combination of policy measures through which the common objectives are to be achieved. It will be for the Member States to decide which set of policies is most appropriate”[85]. An analyse on the European level would identify good practices and innovative approaches that will be presented in a regular joint reports by the Commission and the Council

6.1.2 Open Method of Cooperation

The method of open cooperation serves as a supplement on the integrated approach for support on national polices for safe and sustainable pensions

The appropriate approach on the EU level would be as suggested[86]: “to combine the existing policy processes that are relevant for the future of pension systems with the open method of co-operation in a way that does not change the respective responsibilities of policy makers at European and national level.”

This integrated framework will provide exchange of information on national strategies for securing adequate and sustainable pension provision in the long term. It presents a mutual learning process, setting common objectives, and applies them into national policy strategies[87]. Moreover, this will help Member States perform necessary reforms and make pension’s policy

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83 Dieter Bräuninger, “Pension reforms in the large accession countries”, EurActiv 2002; http://www.euractiv.com/en/enlargement/pension-reforms-large-accession-countries/article-110321 (of 2006-05-11)

84 The commission proposes that integrated national strategies would rationalise the processes of producing the required information and ensure their consistency.

85 Purpose set forth in the Commission Communication stated above

86 COM/2001/0362 final

87 In the CEE countries the use of the Integrated approach was used by periodic monitoring of commonly agreed and defined indicators that helped in harmonising pension and social security polices in the reform processes.

more transparent; based on good practices and innovative approaches through the exchange of experience, and by using commonly agreed indicators to measure progress[88].

The OMC served as a base of the proposal for regulation of the European Parliament and of the Council on the European system of integrated social protection statistics (ESSPROS)[89]. The objective is to establish a framework for foreseeable activities in the social protection statistics[90]. The improvement of coordination between national social polices and EU is possible only in the presence of both quantitative and qualitative information and having the module on pension beneficiaries[91]. Further, collected data will be subject of EU administration (harmonisation and coordination of social protection data at EU level)[92].

The proposal for a legal framework for ESSPROS will improve the usefulness of current data collections in terms of appropriateness, coverage and comparability.
Widening coverage (including qualitative data) will (1) complete and improve quantitative data on expenditure and receipts by scheme and (2) by completing gross benefits with net benefits and identifying the impact of the fiscal system on social protection will allow more comparable data between Member States.

Finally, this will not change demographic trends, but will provide comprehensive knowledge of the different systems and thus make for comparative analysis. The OMC on pensions would provide the unique data source, and by evaluating it, MS and the EU will assess how pension systems are evolving. These systems will provide linkage between country's ageing/expenditure problems and as a result will bring best practices towards reforms. The OMC method will certainly impact harmonisation of national polices by providing that methods used to obtain

[88] One of the purposes that the Social policy Committee (SPC) and Economic Policy Committee (EPC) state in their Joint report of November 12001 on working methods in the areas of pensions and applying the open method of coordination is that "by completing gross benefits with net benefits and identifying the impact of the fiscal system on social protection *on national level) will allow more comparable data between Member States to be available, in particular on the amount of social benefits really received by beneficiaries.

[89] Proposal for a Regulation of the European Parliament and of the Council on the European system of integrated social protection statistics (ESSPROS) /* COM/2006/0011 final - COD 2006/0004 */

[90] As from 2004, the EU covers data on expenditure and receipts by social protection scheme and on pension beneficiaries. Pilot data collections on net social benefits is planned to be prepared.

[91] COM/2006/0011 final

[92] Although the Commission is best able to organise the collection of Community statistics, the Member States are responsible for organising and operating the national statistical systems

pension system's objectives will be agreed upon Community level and therefore transposed into national laws.

6.2 Cross border management and financing of pension schemes

One of the major concerns in the enlarging European Union is to provide a high level of employment and of social protection of its citizens[93]. By creating the internal market, borders have opened and immigration started to contribute towards raising the level of employment. Regardless of the improvement and reforms that are performed on the National level, by which each Member State safeguard its social and employment policy, The European Union stands for an integrated approach, consolidation of these reforms on a European level, promoting mobility and improving the internal labour market. Article 39 of the Treaty establishing the European Union sets forth the principle of freedom of movement of workers. Among the provisions against discrimination[94], Community stands for the free movement of workers among Member States for the purpose of employment. Consequently, on the freedom of purchasing employment among Member States, Article 42 EC put forward measures in the filed of social security where it shall secure "…aggregation, for the purpose of acquiring and retaining the right to benefit and of calculating the amount of benefit, of all periods taken into account under the laws of the several countries…"

Integrated approach would mean coordination of the working methods in the area of pensions promoting Portability of Pension Rights by Member States. Therefore, the Commission has proposed two sets of rules: (1) The elimination of Tax obstacles to the cross border provision of occupational pensions and (2) elimination of investment obstacles in cross border investment of pension funds (for countries that impose domestic savings to be invested in domestic economies[95])

[93] Article 125 EC
[94] Main principle of Article 39 is abolition of any discrimination based on Nationality among Member States as regards employment, remuneration and other conditions for work and employment
[95] See section 8 on the importance of Domestic investments in the Republic of Macedonia

6.2.1 Elimination of Tax obstacles to the cross border provision of occupational pensions

To ensure the sound and sustainable public finances, public pension system's reform must ensure that the tax burden arising from the public pensions is set at an appropriate level[96]. Different national treatments of pension issues and especially diversified mixture of systems that countries use in levying contributions (tax) are seriously distorting the internal labour market and especially the internal market of funded pension schemes.

The potential benefits of better cross-border pension provision are substantial for citizens who take up employment or residence outside their home State and therefore unable to remain in their existing occupational pension schemes[97]. Elimination of tax-obstacles to the cross-border provision of occupational pensions will enable European businesses (pension institutions) from choosing the most efficient way of providing pensions for their employees. It will also make pension institutions more efficient suppliers of capital to business in their capacity as investors in the economy and increase the European industry's competitiveness.

Through this communication, the Commission simplifies the work of the pension institutions by:

1. Creating coordinated approach to a collection of rules current in MS
2. Impose elimination of restrictive or discriminatory tax rules (in particular double taxation) and
3. Present measures to safeguard Member States' tax revenues

In terms of priority in this paper, at the community level Regulation 1408/71 have been adopted to co-ordinate public pension schemes [98]. "Its dual purpose is to avoid double payment of

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[96] Communication from the Commission to the Council, to the European Parliament and to the European Economic and Social Committee, of 19 April 2001, entitled, "The elimination of tax obstacles to the cross-border provision of occupational pensions" COM/2001/214 final

[97] Communication from the Commission to the Council, The European Parliament and the Economic and Social Committee on The elimination of tax obstacles to the cross-border provision of occupational pensions COM/2001/214 final, "Around 5.1 million European citizens aged 15 years and over reside in a Member State other than their Member State of origin. This figure is increasing, and enlargement of the Union will contribute further to this trend". Source: database of Eurostat.

[98] Regulation (EEC) No 1408/71 of the Council of 14 June 1971 on the application of social security schemes to employed persons and their families moving within the Community

contributions in respect of workers who move from one Member State to another and to ensure that benefits are payable across the European Union."[99] It clearly denies discrimination against migrant workers when calculation total amount of pension benefits from those who spend their whole working life in their home country**.**

In terms of funded systems such as occupational pension schemes, regulation of tax obstacles is of greater concern for the Commission. Having regard on the threefold taxation of pensions: on contributions, on the investment and on the benefits, three tax systems EET (exempt contributions, exempt investment, tax benefit), TEE (tax contributions, exempt investment, exempt benefit) and ETT (exempt contributions, tax investment, tax benefit) can be distinguished[100]. These provide citizens the chance to avoid taxation of pension benefits or by mismatching the system to be double taxed. Although Regulation 1408/71 A10, provide that pension benefits can be exported without any restrictions (this is extremely important for migrant workers since many of them return to their home countries when they retire), a coordinated approach on different national legislations towards taxation of pension benefits is an imperative. European Court of Justice (ECJ) has ruled on several occasions against countries (national laws) that granted tax obstacles for pension contributions/benefits. Probably the most important ECJ case that needs to be mentioned here is *Bachmann*[101] where all three principals of the communication[102] are prioritised. The case concerns denial of deduction of contributions to insurance and pension plans written by insurance companies established in other MS, which was concluded to be a restriction of the free movement of workers under A 39. Furthermore, in terms of whether or not a MS can determine in which country contributions are paid the ECJ ruled on the application of the Directive 77/799/EEC on Mutual assistance among MS in terms of automatic exchange of information on occupational pensions[103]. However, on the third principle, the Commission and ECJ have pointed out the need for MS to safeguard tax revenues and attain national fiscal cohesion[104]. Nevertheless, this was the only case that the ECJ accepted this

99 COM/2001/214
100 COM/2001/214
101 Case C-204/90 Bachmann v. Belgian State
102 Com/2001/214
103 Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation
104 In *Bachmann* the Court accepted that restricting the deductibility of contributions paid to Belgian institutions might be justified by the need to preserve the cohesion of the Belgian tax system. This was based on the Court's

argument. In subsequent cases, the scope of fiscal cohesion was delineated "a Member State cannot justify discrimination on the ground that its removal will entail a loss of tax revenue"[105]

Overall, due to the obstacles that has occurred in the cross border management of pension provisions, the Commission calls for harmonisation of different national laws and improvement of communication between authorities governing pension provisions.

Numerous tax law cases have proved that Commission's broader framework is essential and considers the need for legislative measures, and the need to incorporate the *exchange of information on occupational pensions* in these measures[106]. Solutions are found in coordination of tax rules at a European Union level, bilateral agreements or through multilateral conventions.

6.2.2 Elimination of investment obstacles in cross border investment of pension funds

Tax evasion and tax avoidance extending across the frontiers of Member States lead to budget losses and bring distortions of capital movements and of conditions of competition, which affect the operation of the common market. The obstacles of cross border investment of pension contributions further inflate this. This could put considerable strain on the social budgets of the host countries. These obstacles imply to the countries undertaking reforms of the public pension systems, introducing the funded scheme as a second pillar and the need for investment of these contributions.

Cross border investments of pension contributions is another aspect of the "social tourism" initiated by Feldmann[107]. Investment is subject to quantitative rules (at least in the transition economies that need to attract more foreign investments than invest abroad). The question of cross border investment of pension provisions was highly regulated in the new accession

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assumption that there existed under the Belgian rules a connection between the deductibility of contributions and the liability to tax on sums payable by the insurers under pension and life assurance contracts.

[105] COM/2001/214

[106] In COM/2001/214, The Commission considers that at a later stage consideration could be given to extending information exchange to third pillar schemes, including life assurance.

[107] Horst Feldmann, " How Social is European social policy?" International Journal of Social Economics, Bradford, 2002. Vol.29, Iss.7/8; pg.547, 28 pgs; defined "social tourism" as: needy workers migrate to countries with more generous transfer payments.

countries. For example in Hungary, Poland and the Czech Republic, pension reforms and the investment of the funds collected in the second funded pillar were su*bject to quantitative rules*[108]*:* "At least 10% of assets must be invested in vehicles of the lowest risk category; no more than 30% may be held in the riskiest asset class. A maximum of 50% *must be invested* in domestic equities. Foreign assets should stand at 30%, with at most 10%-points to be invested in non-OECD countries."[109] Even tighter restrictions on investments abroad were lifted at the beginning of 2002.

These restrictions apply mostly in the Countries, helpless to safeguard national Economy and increase the investment incentives provided by the pension funds towards economic growth. However, both EU10 and new candidate countries acknowledge the provisions entitled in the EC Treaty on free movement of capital and therefore the requirements for consolidation of the national laws towards investment of pension contributions across Member States[110].

The Integrated approach, open method of cooperation and simplifying cross border management and investment of pensions are the main Community approaches that address pension fund's demanding caused by ageing population. However, more than once I stated that these approaches only give directions to national polices, but they do not provide more efficient means to combat challenges than joining forces and exchange of information in order to encourage exercising best practices of pension reforms in European countries. These directions are of furthest use for candidate countries such as the Republic of Macedonia as we will see in the following section.

6.3 The European Model - Constructing the Multiple Pillar Pension system

In order to assess different policy options for the reform of the pension systems, a deeper analysis of the multiple pillar systems is presented. Member States in order to provide older people's income support combine three main pension schemes: Social Security plans, Individual

[108] Palacios, RJ. And Rocha, R., 1998, Gora, M. and Rutkowski, M., 1998, Schwarz, A. , 2004,
[109] Dieter Bräuninger, 2002 "Pension reforms in the large accession countries", EurActiv
[110] Approximation of laws towards pension investment will be further described in the case of Macedonian reforms and obligations imposed by the EU in the *acquis* on social protection

schemes (life assurance contracts) and Occupational Schemes. They all differ in the forms of financing[111] and the way they are calculated such as nationally run plans, funded retirement plans, and intermediate form of plan funding respectfully.

6.3.1 Financing of Pension Schemes

1 ***Nationally run plans*** are also known as pay-as-you-go (PAYGO) systems, which mean that taxes (contributions) collected in the given year are used to pay benefits in the same year. These plans are unfunded; they are paid in the same moment as they arrive in the budget for promised beneficiaries and usually benefits have no relationship to taxes that are paid in, either for individuals or for entire generations of participants. These plans present the redistribution goals of pension systems, providing a support mechanism for a poor cohort by future generation of workers.[112]

2 ***Funded retirement plans*** characterize with investing contributions on continuous basis aiming to generate savings and increase the potential of future retirement benefits. Eventual future income is highly dependent on the performance and division of retiring workers' available asset pool[113]. Well-diversified portfolio of financial instruments will bring higher present value in annuity form for retirees. This type of financing pension funds do not require redistribution across generations and increase national saving which impact the development of national capital markets.

3 ***Intermediate funded plan,*** combine features of both funded and PAYG systems. This financing alternative is implementing in many countries that have started with reforms in their retirement systems imposing that worker contributions are investing in pension fund and part of

[111] Larry Willmore, 1999; " Public versus Private provisions of pensions", DESA Discussion Paper No.1, New York, United Nations
[112] Mitchell, O. S. , "Retirement systems in developed and developing countries: institutional features, economic effects and lessons for economies in transition", working paper No. 4424, p.23- 29, National Bureau for economical research, Cambridge , August 1993,
[113] Hellner, J. and Nord, G., "Life insurance Law in International Perspective", Forsakringsjuridiska Foreningens Publikation Nr.20, Stockholm , 1969

them are further reinvesting in financial instruments primarily as government bonds but also using international portfolio.

6.3.2 Defined Benefit and Defined Contributions

Regarding calculation of pension provisions one can distinguish defined contributions plan and defined benefit plan[114]. Typical calculations of the provision are through redistribution of different levels of incomes, defined by working period or average salary of workers[115]. These are also known as defined pension provisions, where future benefits depend on the years of work and average salary calculated according to the pension formula[116].

The main pillar of the pension system in many countries (even after refoms) is compulsory public pension scheme. The structure of these plans consists of compulsory contributions collected by employees as a prerequisite to the right of pension provision. The main reasons why these schemes are unpopular originate in the high dependence of demographic changes and rate of increase in the average salaries. Consequently, in a shortage of assets, public plans, provide that governments will cover this lack in means by using national budget funds.

In the defined contributions schemes, pension provisions are calculated based on individual's contributions to the system, realizing certain return on their investment, including the interest in the given year. In this system, pension provisions depend on the whole working history of the individual and accumulated rate of income. Provisions are as much as the individual have on its account and there is no space for lack of returns.

[114] Marek Góra and Edward Palmer, " Shifting Perspectives in Pensions, Institute for the Study of Labour (IZA), Discussion paper 1369, October, 2004, Bonn Germany
[115] Hellner, J. and Nord, G., "Life insurance Law in International Perspective", Forsakringsjuridiska Foreningens Publikation Nr.20, Stockholm , 1969, " The coordination of life insurance with social insurance, Insured and Non-insured pension plans and Similar schemes" Ch 3
[116] Income related pensions: <u>P = SB x AR x YC</u>; Where: P = amount of the pension, SB = Salary Base, AR = Accrual rate, YC = Years of contribution

6.3.3 The matrix of pension schemes

The matrix of pension schemes regarding Funded/Unfunded and Defined benefits/contributions is presenting the main options on the multiple pillar system

Table 2. Possible Pension Schemes

	Non-funded	Funded
Defined benefits	NDB (Traditional PAYG systems)	FDB (Traditional Occupational systems)
Defined contributions	NDC (Imaginary accounts)	FDC (Compulsory and voluntary savings plans)

Source: "Shifting Perspectives in Pensions", IZA, 2004

Generally, Defined Benefit schemes entail taxes on some to provide transfers to others[117], while, Defined Contribution schemes involve only reallocation of an individual's consumption over the lifetime[118]

6.3.3.1 Non-funded Defined Benefits plan (pay-as-you-go systems)

With this system the old age support originates from Public or State-run system usually and most common in Europe as Social security retirement plans. One of the main characteristics of this system is that they have defined the pension provision and there is no relation between the benefits and contributions.

[117] Figure 1, Bizmarkian Cross-generation solidarity system
[118] Marek Góra and Edward Palmer, " Shifting Perspectives in Pensions, Institute for the Study of Labour (IZA), Discussion paper 1369, October, 2004, Bonn Germany, Pg.6

Some NDB systems, such as in Australia and to some extent in Sweden, provide with fixed provision, regardless of the employment history or employees incomes[119]. Other makes alignment with the number of years and contribution to the system, such as in United Kingdom. Non funded Defined Benefit systems in continental Europe calculate progressive provisions according to employee's incomes, those who had high income have higher pensions and *vice versa*.

The advantages of this system stand in the possibility to perform redistribution of wealth between different cohorts in the society. Non-funded defined benefit system founds on intergenerational agreement where current working force finance current retirees. Although, these schemes are commonly used because they secure individuals from investment and market fluctuation risks, as well as from invalidity and sickness, they are highly unstable of demographical and political risks. Non-funded defined benefit plans are also one of the main destructors of the individual's confidence towards pensions systems. The lack of transparency is main flaw of the system since one usually does not know whether has fulfilled the conditions of the defined benefit plan until the time of retirement[120]

6.3.3.2 Funded Defined Benefit plan (Occupational Schemes)

Another form of pension system argued by Góra and Palmer (2004) is Funded Defined Benefit plan (FDB). These plans have the advantage before other since they provide petite administrative expenses and are not influenced by the public sector. According to report of the World Bank in 1994, the difference between the NDB (PAYG) and FDB (some occupational schemes) is that employees do not calculate their occupational contributions as a tax.

Generally, occupational schemes are run by pension sector and they can be implemented as funded, unfunded of intermediate funded; they can be connected to one company or by whole

[119] Kruse, A. and Palmer, E. "The New Swedish Pension System- Financial Stability and the Central Government budget", Paper to be presented at the Urban Institute's International Conference on Social Security Reform, 24 February 2006

[120] Marek Góra and Edward Palmer, " Shifting Perspectives in Pensions, Institute for the Study of Labour (IZA), Discussion paper 1369, October, 2004, Bonn Germany, Pg.7

industry. In any case, they are subject to vast regulations[121] and provisions on International and National level[122].

There are numerous mechanisms by which FDB plans can influence national savings and therefore enhance the financial footing of the pension system: since benefits are connected to the contributions employees save more (in many developing countries this was perceived as an opportunity to retire earlier). Moreover, tax stimulations through FDB increase the rate of return of savings and that replicates in increase of the aggregate savings ratio.

6.3.3.3 Funded Defined Contributions plan (compulsory private saving plans)

These systems can be state-run or on voluntary basis where the government usually provides financial motivation. These schemes have defined contributions and are entirely funded which illustrate the direct link between pensions and contributions. The risks that occur in these plans are the Investment risk and variable rates of return.

One of the most important models of FDC is compulsory private savings plan. Their primary motivation is that young generations are not willing to save due to the short sight and instability of savings instruments. Similarly, old-age population has preferences, which are inconsistent with time (regretting that they did not save when young), and they become burden on the society (moral risk). Supporters of the compulsory pension plans emphasize that these problems will diminish by obliging people to redistribute their current consumption and use financial institutions for generating their incomes when retiring. Pension Benefits in FDC depend on contributions and the rate of return from the investment. Among the many positive effects of these schemes, supporters add influence of the long-term savings, effective allocation of capital (development of capital markets), efficient labour markets, distribution of wealth, reducing the poverty, and by these variables generating economic growth.[123]

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[121] COM/2001/214; Directive 2003/41/EEC;

[122] International Labour Office, 1999, "The structure, Development and Reform of Pension Systems Around the world", Geneva

[123] James, E., "Averting the Old age crisis polices to protect the old and to promote growth", World Bank, Oxfor University, London, 1999

However, detractors of these plans, emphasize the problems that these schemes may impose: (1) privately-run schemes cannot insure from “bad investment” of the contributions (information asymmetries, lack of experience); (2) these schemes neither support low-income cohorts nor provide appropriate pension provisions in the first years of the scheme.

The difference among FDC, NDB and FDB are under examination among economists and analysts (NDC are quite new construction). Some state that pension schemes do not have effect on national savings and consumers make trade off with taxes or contributions with other forms of savings. Others argue that compulsory schemes can contribute to savings much more than if there is no obligation for that. However, the most common argument among the theoreticians is that the accumulation speed of long-term resources depends primarily of the system that country uses (old or new), its structure, and the level of contributions.

Funded Defined Contribution schemes would be most appropriate in countries with high GDP *per capita,* where people have enough and quality information about investment opportunities, financial markets with variety of instruments, and very efficient regulatory institutions. These plans can support population with average or high income but they do not provide efficient provisions for low-income cohorts. Therefore, in countries adopting this method, in order to lessen long-term poverty, and diversify the risk, minimum pension provision guarantees are added.[124]

6.3.3.4 Non-Funded Defined Benefit plans (Imaginary accounts)

The last alternative is relatively new combination, legislated in Sweden (since 1994)[125] comprises defined contributions and completely unfunded savings (Imaginary bills). With these plans employees accumulate their pension contributions based on the rate of contributions and imaginary interest rate (which can be market value, or as in Sweden, where there are alternative

[124] Philip Davis 2002 “ Policy and implementation issues in reforming pension funds” EBRD, London
[125] Kruse, A. and Palmer, E. “The New Swedish Pension System- Financial Stability and the Central Government budget”, Paper to be presented at the Urban Institute’s International Conference on Social Security Reform, 24 February 2006

rates of economic growth which are used to calculate pension contributions). When retiring, pension managers transform these bills into pension annuities.

Advantages for this approach, is system transparency and close connection between contributions and provisions. Yet, the system is not funded, individuals bear the risk of over aging and society is vulnerable on demographical and economic risks.

7. Reform options – making the perfect mix of possible polices

Most of the public pension systems designed in the 19th century were based on the demographic factors, considering the average life expectancies on the much lower level than today or in the future; based as unfunded systems or partly funded plans; and including basic mechanisms through which pensions were offered to the first working generation covered by these schemes.

Due to macroeconomic, demographic, social and microeconomic factors elaborated above, these schemes were under big pressure and their sustainability had become alarming issue. Making long-term projections of the systems, IMF and OECD studies showed that retirement systems are not sustainable in terms of contributions and there is a need to reduce the solidarity provided by pensions.

First round of reforms undertaken in developed countries in mid 1980s was mostly focused on parametrical reforms. These in United Kingdom included modification of the pension regulations and contributions, rules for indexation, retirement ages, penalties for early retirement and taxation of provisions.

In the same time, many countries outside OECD have switched to the completely funded pension schemes as a solution in making these systems more sustainable.
Reform options can be classified in Parametrical (smaller) adjustments and Systematic (bigger) reforms.

a) Parametrical reforms are used on a short-term basis and they are effective in delaying fiscal harms. They can be present in many forms such as Governmental regulations for: pension criteria, level and structure of contributions, structure of pensions, or combinations of some adjustments. Unfortunately, these reforms are not enough to solve problems of the public pension schemes, but as previously mentioned they just postpone fiscal crisis.

- *Alteration of pension criteria* means revision of the age of retirement or working years needed for the retirement status. In every country, except Greece, there has been increase in the age of retirement, consistently with the increase in the life expectancies[126].

- *Modification of the contribution's structure* means changes in the contributions rates and the bases for calculating provisions. These reforms were most adoptive solution by countries. Since contributions were levied as a percentage of wages, around 75% of the adjustments were shown as an increase in the rates of contributions of the employers. Among highest increases are marked in transition economies such as Bulgaria, the Czech Republic and Albania[127].

- *Revision of Pension's Structure* means correction in the formula for pension indexation according to the inflation. Most significant improvements will be marked in countries that use *ad hoc* adjustments to the inflation with structural amendments including prices and wages fluctuations.

b) Systematic reforms present radical changes in the system for example from defined benefits to defined contributions, or from unfunded to funded. Until now most of the countries have undertaken pension reforms but only 25% of these can be defined as systematic reforms[128], one third of the system reforms include switching from unfunded to funded plans and other reforms present only smaller adjustments of the current PAYG systems. Many countries such as Poland and Hungary, introduced FDC but choose to have primary pillar of PAYG defined benefits plan.

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[126] Robert Holzmann and Richard Hinz, 2005 ; "Old-Age Income Support in the 21st Century", The World Bank's Perspective on Pension Systems and Reform

[127] Vladimir Filipovski, "Capital Market and development of financial sector in the procesas of economic transition", Skopje, 2003

[128] OECD 2005

Countries were also obsessed in how to provide social security for the poorest cohorts such as those with no or less working years. This was solved by introducing minimum pension guarantee and minimum benefits included in the first pillar of social security such as in Poland, Hungary, Argentina and Latvia[129]. These reforms often embrace decisions for transitional mechanisms such as when switching to FCD systems, current workers contributions are collected on their accounts, therefore employees contributing to the second pillar will always have less on their individual accounts then those having same working years but under new system. In order to maintain equality, there are number of mechanisms that can lessen transition such as issuing bonds, calculating provision as a percentage of the years worked by older system or adding both provisions when retiring.

7.1 Evaluation of different policy options

Countries commence different approaches in reforming retirement systems, one can distinguish best and worst practices in countries that have already made some reforms, yet the question is: is there a "paramount" strategy and choice in the transition; and is it consistent with primary goals of the reforms?

The transition from a wholly public, pay-as-you-go pension system to completely funded schemes or to privately managed pension accounts does not directly affect those receiving pensions at the time of the reform[130]. The matrix pension system has to be designed to perform high level of protection for members and beneficiaries of pension funds and to offer maximum degree of efficiency and security for the ones that finance those benefits.[131] Different possibilities on disposal may be examined through the externalities that systems offer. In the individual examination of the Defined Contribution schemes one can see that they are efficient with no

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[129] Palacios, RJ. And Rocha, R., 1998, "The Hungarian pension system transition", Social Protection discussion paper no. 9805, World bank
Gora, M. and Rutkowski, M., 1998, " The quest for Social Security Reform: Poland's Security through diversity", Social protection discussion paper no.9815
[130] World Bank Pension reform primer paper series, 2005, "Switching : the role of choice in the transition to a funded pension system" Vol. 1 of 1
[131] Directive 2003/41/EC Pension Funds Directive, Institutions for Occupational retirement provisions

negative externalities, what so ever, on the financial base of the pension systems. Contrarily Defined Benefit schemes are not efficient, and do create negative externalities in terms of *Rates of Return*, they can vary between individuals in the same birth cohort, depending on when they enter and leave the scheme, their *Calculation of annuities, Demographic reserves, Funding etc.* After examination, one can say that DC schemes are generally superior to DB schemes although depending on their construction and individual behavioural responses.

One of the more important externality is the possibility to evade payment in a universal public system, which is minimised with DC. Defined Benefit schemes lack well-motivated redistribution to poor pensioners. This negative externality is covered by a separate mechanism such as a guarantee and minimum pension benefits. Further countries commence different approach in order to improve individual perception of the pension system by motivating them in order to contribute more to the public pension system.

Individual retirement decisions also depend on what system is used (NDC and FDC schemes are neutral with regard to the individual retirement decisions). This externality reflects the risk of moral hazard. DB schemes give rise to an increasing future tax wedge (progressive tax/contribution) which increases the risk that the pension system will affect economic growth and thereby decrease employment.

True, DC is potentially superior to DB because it can create saving and promote financial market development. Further, DC is financially stable, and because they are simply lifecycle saving schemes for individuals, however, they must be supplemented by social policy with distributional aims. “This makes FDC and NDC systems transparent and economically efficiently, whereas DB schemes will have tax wedges, and may entail obscure and or unfair distribution rules resulting from the DB formulas.”[132]

According to previous analysis and difficulties mentioned in previous sections a general conclusion should be that: the mix of Pension Systems need to be composed as to (1) be

[132] Marek Góra and Edward Palmer, “ Shifting Perspectives in Pensions, Institute for the Study of Labour (IZA), Discussion paper 1369, October, 2004, Bonn Germany

financially sustainable on a long term (2) to increase economic efficiency my minimizing labour market distortions (3) to support the development of the capital market and (4) to create savings.

8. Following the European Model – Transformation of Public Pension Funds in Republic of Macedonia - The challenge of candidate countries

8.1 Community measures on the application for accession of the Republic of Macedonia towards national Social and Employment policies

After Republic of Macedonia submitted the application for the accession in the EU, the country was subjected on systematic changes of the three substantial polices[133]: Employment, Social Security and Economic policy. Moreover, in its opinion the Commission evaluates the ability of the Republic of Macedonia to assume the obligations imposed by the community by implementing, adopting and enforcing the *Acquis*[134].

The acquis imposes approximation of Community and Macedonian legislation in the following fields:

- Social policy and employment;[135]
- Freedom of movement for workers[136];
- Free movement of capital;
- Financial services;

[133] For the purpose of this paper other policy recommendations by the Commission will be excluded

[134] Government of the Republic of Macedonia, Secretariat for European Affairs, "Draft National programme for adoption of the A*cquis Communautaire"*, Skopje, March 2006, pgs 78-82, 89-92, 113-117; http://www.sei.gov.mk/portal/eng/npaa/01%20NPAA.pdf

[135] Main acts needed to be transposed into national legislation 2001/458 EC; Commission decision on the setting up a committee in the area of supplementary pensions; Regulation 1408/71 and Regulation 1223/98 amending 1408/71 on the application of social security schemes to employed persons, to self employed persons and to members of their families moving within the Community; http://www.sep.gov.mk/npalreports/documents/EuSlMk.pdf

[136] Main Community acts waiting to be transposed into national legislation: Council Directive 68/360/EEC on the abolition of restrictions on movement and residence within the Community for workers of MS and their families, Regulation EEC 1612/68 on freedom of movement of workers and amending Part 2 Reg. 2434/92; http://www.sep.gov.mk/npalreports/documents/EuSlMk.pdf

Moreover, these obligations not only impose change and harmonisation of national and community law, but also adopting and implementation of directives in the field of Pensions and employment issues. Some of the selected criteria in the a*cquis* will be discussed below.

8.1.1 EU *acquis* on the Employment policy in the Republic of Macedonia

The Council adopted a European Partnership for the Republic of Macedonia in 2004[137]. Along with the present Opinion[138], a revised Partnership was proposed. The purpose of the European Partnership is to assist the authorities in their efforts to meet the accession criteria. It covers in detail the priorities for accession preparations, in particular implementation of the *acquis,* and forms the basis for programming pre-accession assistance from Community funds (the European Social Fund)[139].

In 2003 the Republic of Macedonia adopted a National Action Plan on Employment[140] in accordance with the EU Employment Guidelines. The country has had persistently high unemployment since the beginning of the transition in 1991[141]. A high level of long-term unemployment, low and static participation and a low and falling employment rate mark the situation of the labour market. The official unemployment rate rose to about 39% in 2004[142], particularly affecting young people. Due to the scale of the grey economy and the lack of standard indicators significant number of people are registering as unemployed only to gain access to health care, which is a serious impediment to assessment of the labour market[143].

[137] Council decision 2004/518/EC of 14 June 2004 on the principles, priorities and conditions contained in the European Partnership with the Republic of Macedonia (OJ L 222, 23.6.2004, p. 20).

[138] Extract from the Presidency Conclusions of the Brussels European Council Granting the Republic of Macedonia Status of a EU Candidate Country , Brussels 17.12.2005; http://www.sei.gov.mk/Documents/eip/conclusions_en.pdf

[139] The focus of assistance has been on measures promoting initial vocational training, advanced training and retraining, as well as employment subsidies for the primary and secondary labour markets. The target groups include not only jobless persons (specifically the long-term unemployed) and young people (particularly within the framework of initial vocational training), but also workers threatened by unemployment.

[140] The plan was prepared on the basis of dialogue with all relevant actors and includes among other things the reform of the Law on Labour Relations and the reform of the Employment Agency

[141] The transition to a market economy in 1991 started with an already high unemployment rate of 24%; COM /2005/562

[142] Analytical Report for the Opinion on the application from the Republic of Macedonia1 for EU membership COM /2005/ 562 final

[143] This also partly explains why withdrawals from the labour force have been relatively limited and why participation is rather static around 60 to 62%.

Employment policy reforms will comprise revision of the labour regulations; the new employment policy is determined as a concept of active labour market measures directed at promoting the creation of new job opportunities, at activating jobless people and at human resource development[144]. As regards preparations for the European Social Fund (ESF), the Republic of Macedonia must organize its structures and adopt new legislation in order to strengthen its administrative capacity for management, implementation, monitoring, to modernise the administration in this field and to provide adequate resources for ESF-type measures at both national and regional levels.

8.1.2 EU *acquis* on the Social policy in the Republic of Macedonia

The commission concluded that a strategic multi-dimensional approach to social exclusion and poverty in Macedonian society is essential as a basis for future programmes for vulnerable groups[145]. One area where improvement is important is the alignment of national data with European indicators (poverty indicators, pension benefit expenditures as a percentage of GDP etc.). Progress is necessary in the fight against social exclusion. The social protection network in the country does not cover all the affected groups, due to a shortage of financial, human and institutional resources[146].

Council opinion on the social security in the republic of Macedonia is that "*The pension and insurance system will need to be reformed to meet the demographic challenges, in order to make it more adequate, sustainable and adapted to changes in society. The system still suffers from past difficulties associated with the 2001 crisis and the ensuing economic downturn. Overall, the Republic of Macedonia will have to make considerable and sustained efforts to align its legislation with the acquis and to effectively implement and enforce it in the area of social policy and employment in the medium term.*"

[144] Measures undertaken are mainly implemented by the Employment Agency
[145] COM/2005/562
[146] COM/2005/562

8.1.3 EU *acquis* on the cross border investment of pensions in the Republic of Macedonia

The *acquis* in the field of financial services includes rules for the authorisation, operation and supervision of financial institutions in the areas of, insurance, supplementary pensions and investment services[147]. By these recommendations, Pension Companies, Pension Funds and Pension Agencies[148] should operate across the EU in accordance with the "home country control" principle, either by establishing branches or by providing services on a cross-border basis.

8.2 Challenges of the public pension system in the Republic of Macedonia

Problems that R. Macedonia is facing with in the performance of the public pension funds were present in most of the CEE countries joining the EU in 2004[149] and they originate from ageing population. Main indicators of the ageing population such as fertility rates are on the lower level than the necessary to maintain favourable age structure for the public pension fund to function[150]. Following this trend, in the future there will be much more pressure on the public pension system in order to safeguard the fiscal requirements with its abilities[151].

Macedonian pension system is entirely under state control and integrated into the government budget. The public pension scheme is structured along socialist principles and compliant to national interests; free-market incentives and belief in the equivalence of eventual pension benefits to pension contributions is not a system feature[152].

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147 COM/2005/562

148 Article A3 of the Law of mandatory fully funded pension systems in the Republic of Macedonia of 2002 defines: (1)Pension Company as “a joint stock company that is the governing body of a Pension Fund and known as a “Universal Pension Company”; (2)Pension Fund - as “an Open Pension Fund established and managed by a Pension Company” and (3) Agencies “that supervises the operations of the Pension Companies and Pension Funds.”.

149 Deutsche Bank Research Group, “Pension reforms in the large accession countries”, 2002’; Euractiv: http://www.euractiv.com/en/enlargement/pension-reforms-large-accession-countries/article-110321

150 State Statistical Office in the Republic of Macedonia “Population projection in the Republic of Macedonia, 2002 - 2055 by sex and age, by regions”, Skopje, 2003

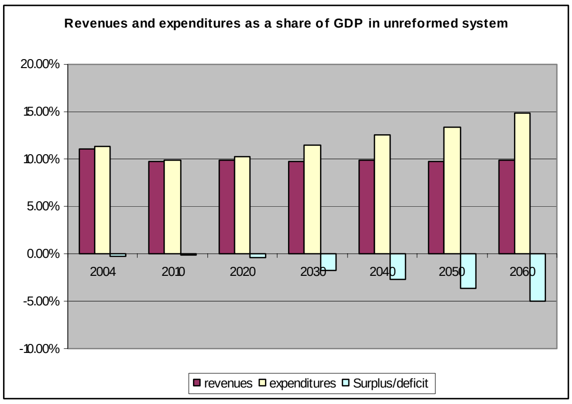
151 Ministry of Labour and Social Policy and Pension and Invalidity Fund, “ Suggestions for the reform of the Public Pension System in the Republic of Macedonia”, Skopje, 1999

152 COM/2005/562

Rapidly growing expenditures are building the public debt[153]. To finance pensions, contributions are collected from employees (at flat rates based on the wage bill). As distinguished in the previous section, the size of individual pensions is unrelated to the contributions in public pension schemes, and in many cases, it was determined by individuals' pay in the final year or years before retirement[154]. The system promotes special privileges as for individuals in occupations promoted by the government or in sensitive professions.

However, socio-economic variations in past several years, due to the transition towards market-oriented economy, exposed the pension system with high level of insolvency and inability to accomplish its main functions. The employment rates were continuously declining, which resulted with decreasing the share of active workforce and increase in the share of the retirees. Since 1999, the Macedonian Government performed parametrical reforms, in order to maintain balance between revenues and expenditures and decrease the already high pension expenses as a share of GDP[155].

Figure 3. Financial position of the pension fund in Macedonia

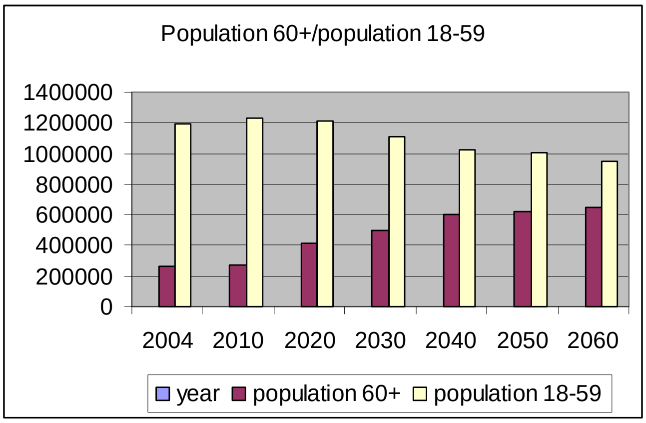


These reforms only provided the system with short term or middle term balance and according to long-term actuarial projections, regarding the similar reforms in CEE countries[156], would lead to multifarious instability. Last decade was marked as the "pension reforms decade" since all newly accessed EU countries undertook reforms on the national retirement systems, advocated by the European Union. Consequently, actuarial projections on the ageing population were undertaken in the Republic of Macedonia. According to these projections the share of the age group 60 +, in those between 18 and 59 measured as

[153] Pension and Social Security Fund of Macedonia, "Yearly report on the Pension Fund 2002", Skopje, 2003
[154] Under socialist rule, most pensioners belonged to the financially disadvantaged echelon of society. In many cases, current pensions were inadequately indexed to general wage and price increases and thus lost significantly in real value over time.
[155] Ministry of Finance, "Financial System in the Republic of Macedonia", Skopje, 2002
[156] Dieter Bräuninger, 2002 "Pension reforms in the large accession countries", EurActiv

from 2004 (24%) is going to rise on 34% by 2020, 41% in 2030 and maximum 64% until 2060[157].

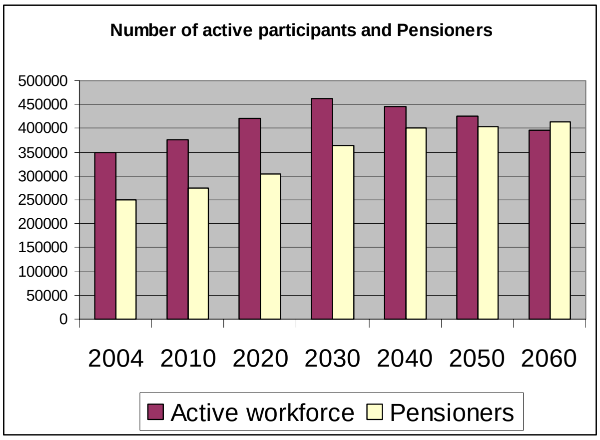
Figure 4. Age group over 60 / 18-59 age group



Source State Statistical Office in R. Macedonia

These profound demographical changes are pressuring the Macedonian pension system financed on the Pay-As-You-Go basis. It is undisputable that this system is highly exposed on the share of retirees in active workers. Under these demographic and socio-economic assumptions, lack of reforms in the public pension system will raise the public deficit permanently as the ratio of workers per retiree is declining. Currently the European Union is facing the ratio of four workers per elderly citizen[158] and in Macedonia projections until 2020 show that there will be nearly one worker supporting one pensioner[159].

Figure 5 Share of workers/retirees projections 2004-2050 of State Statistical Office



Unless a reform is undertaken, the ratio of pensioners and workers will continuously increase and the defined contributions (flat rates based on the wage bill) will follow the trend from current 21% to nearly 40%. This dramatic increase will abbreviate worker's

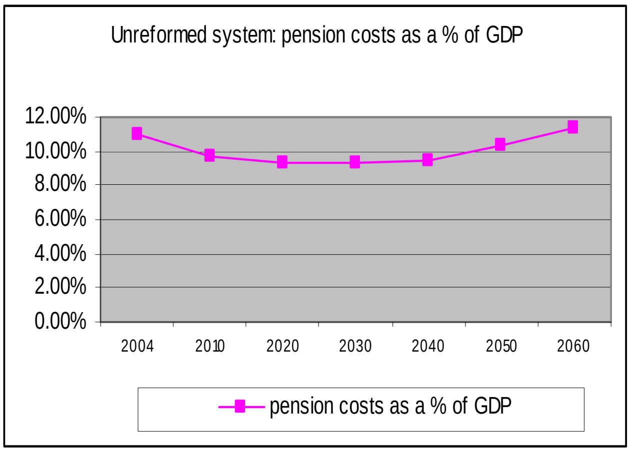
[157] State Statistical Office in the Republic of Macedonia “Population projection in the Republic of Macedonia, 2002 - 2055 by sex and age, by regions”, Skopje, 2003

[158] The European Commission and Economic Policy Committee Economic “report on the huge challenge to pension systems” published 14 February 2006; In this communication Monetary Affairs Commissioner Joaquín Almunia stated: "While the process of an ageing population cannot be turned around some Member States have already carried out reforms to avoid overburdening future generations. Unless this is done, many EU countries, from the old to the new members, will simply not be able to face the cost; not when there will be two workers per elderly citizen as opposed to a ratio of four to one now. The prospects of much lower growth combined with the risks to the sustainability of public finances vividly underline the need to live up to commitments to implement the Lisbon strategy and to modernise welfare systems."

[159] State Statistical Office in the Republic of Macedonia “Population projection in the Republic of Macedonia, 2002 - 2055 by sex and age, by regions” Skojpe, 2003

income, the potential for economic growth and will further increase the unemployment rate. Furthermore in the projections made by the State Statistical Office in Macedonia, if there is no reform, pension costs will rise to the outstanding 11,3% of GDP until 2050[160].

Figure 6. Pension costs as a percentage of GDP



These number show that the reform is inevitable, not only for the financial sustainability of the pension system but for the preserving the economic growth in general.

Reform package according to the Ministry of Labour and Social Policy will comprise suspending the retirement age, decrease in the ratio pension/wage, rearrangement on the indexation rates, and transforming the public pension system into two-tire system.

8.3 Reform Options in the Republic of Macedonia

With the objective opinion on the situations and reforms in the Republic of Macedonia[161], and by granting the candidate status[162], the EU has sent a very important message that The European transformation of the Social Policy in the Country is possible and it has an immediate character.

In order to simplify the process and to provide a full systematic reform of the public pension system a Committee for design of the pension system[163] has been created. For the benefit of

160 State Statistical Office in the Republic of Macedonia, “Gross Domestic Product of the Republic of Macedonia 2004”, Skopje, 2005

161 Communication from the Commission - Commission Opinion on the application from the Republic of Macedonia for membership of the European Union (COM (2005) 562**)**

162 Extract from the Presidency Conclusions of the Brussels European Council Granting the Republic of Macedonia Status of a EU Candidate Country , Brussels 17.12.2005; http://www.sei.gov.mk/Documents/eip/conclusions_en.pdf

163 The committee runs under the Ministry of Labour and Social Policy. Its members are primarily form MLSP, Pension Fund, Ministry of Finance, Macedonian Central Bank. It is also in permanent cooperation and consultations with international and local organizations such as the World Bank.

performing a painless reform on the public pension system, the Committee distinguish two types of goals: primary and additional. Primary goals are:

1. security in obtaining the right to a pension benefit and insurance
2. providing short and long term solvency of the Pension fund (financial sustainability)
3. maximum security and minimum risk
4. guaranteeing legitimate pension benefits for all generations
5. strengthening the confidence of the citizens in the public pension system throughout success in the previous objectives

Additional goal is introducing of the third pillar of pension systems- private pension savings, which will affect national savings on the long run and will reinforce the investment rate in the country promoting economic growth.

Starting from the societal-economic condition of R. Macedonia, and analyzing possible reform options, the Committee chose to introduce the multiple pillar pension system, at first concentrating on the transformation of the public pension fund (regarding the transitional costs) and subsequently introduce additional changes in the system.

8.3.1 Reform of the public pension system

By introducing the two-pillar system (the first reform), the contributions normally paid to the first PAYG[164] system will automatically split in the second compulsory-funded tire. The Law on mandatory fully funded pension insurance[165] define the principles of the scheme, establishment and operation of Pension Funds and their governing Pension Companies, which shall operate as part of the pension and disability insurance system[166]. According to the Law of 1994, workers contributions to the pension and disability insurance was estimated on 21,2% flat rate deducted

[164] According to the Law of pension and disability insurance, applicable since 1 January 1994,
[165] Law on mandatory fully funded pension insurance 2004, Macedonia
[166] The purpose of these funds and companies is to receive contributions from those required by Law to contribute to such funds, to invest in financial resources, and to distribute accumulations in accordance with Law, Article A1 (2), Law on mandatory fully funded pension insurance

of the monthly (gross) wage. This sum is proposed to be divided in the first PAYG scheme and in the second fully funded scheme. By this reform, contributions in the pay-as-you-go system will decrease substantially and there will be insufficient funds to cover pensioners. These are called "transitional costs", and depend on how fast the transition period will pass and how prompt the employees will consider switching to the second funded system[167]. This gap can be financed from several sources: issuing public debt (long-term government bonds), sources from privatisation, or by using financial contraction (decreasing public consumption by imposing higher taxes).

Statutory scheme works on the principle of solidarity and uniformity, obtaining the right of benefit regarding wages and contributions (Defined Benefit). Second tire's main function will be to maintain the income of elderly by collecting savings on individual accounts, capitalising them considering the interest rates of the investments, and obtaining pension benefit through Defined Contributions. Furthermore, the Pension system in Macedonia, with the law of 2004[168], includes the possibility for voluntary completely funded pension and disability insurance schemes that will provide even more income protection for the elderly.

Supported by the Ministry of Labour and Social Policy, the Employment Agency, the State statistical Office and the Pension and disability fund in the Republic of Macedonia, I completed a comprehensive analysis on the pension system options proposed by the Macedonian Government[169] advocated by the EU[170].

Constructing possible options needed a detail analysis on the financial position of the pension fund in Macedonia (revenues and expenditures as a share of GDP), the rate of pension benefit in regards of the wages, the scale of the transition deficit and possible options for the transition,

[167] World Bank Pension reform primer paper series, 2005, "Switching : the role of choice in the transition to a funded pension system" Vol. 1 of 1 No. 33388
[168] Law on mandatory fully funded pension insurance 2004, Macedonia
[169] The Republic of Macedonia has opted for a mix of two systems, first the defined benefit and non-funded system known as the Public Pension system, and the Second fully funded defined contribution scheme. The difference in the treatment of the two options lies in the percentage of the contributions that are withdrawn on a monthly basis from worker's salaries.
[170] Questionaire from the Commission to the Republic of Macedonia of the Social Policy and Employment; http://www.sei.gov.mk/download/Questionnaire/3-13%20-20Social%20policy%20and%20employment.pdf

number and structure of the persons that will shift in the new system and the influence of the already recommended reform options for the pensions[171]. Main parameters of the current system are presented in the Annex 1.

Option 1

First option represents the current chosen reform option by adopting the law of mandatory fully funded pension system in 2004. It proposes a mix of the Public pension system Non-funded with defined benefits, and Fully funded system with defined contributions[172].

State pension system (NDB)

- cover three types of pensions (old, invalidity, household) and supplements to minimum pension benefits
- defined benefit yield with flat rate of return 30 % for full years of working (62 for women , 65 for men)
- contribution rate of 13% of the monthly gross salary

Fully Funded system (FDC)

- Exclusively old age pension
- Benefit according to defined contributions
- Contribution rate of 7% of gross salary

The strategy envisages compulsory including of all new entrants on the labour market[173] and voluntary for current workers[174]. Many countries opted for the middle path of switching with young workers participating in the new scheme and older left on voluntary switching. Workers that voluntarily enter in the second system will exercise the rights governing the new pension scheme, with the five years exception under the law on the previous scheme.

[171] Current reform comprise the adoption of the fully funded pension system Law in 2004, which basically shift part of the contributions in the new schemes and lower the benefit base in the statutory scheme.
[172] Ministry of labour and Social Policy and pension and disability fund in the Republic of Macedonia, “Suggestions for Reform of The Public Pension System in the Republic of Macedonia”, Skopje, 2000
[173] Reform Practice in Chile 1981 and Hungary in 1997
[174] As in Argentina 1994 and United Kingdom 1998

Old age pensions will be rewarded in two parts: from the first pillar and remuneration from their own accounts in the second pillar. Household pensions will be remunerated on the principal as the invalidity pensions. If any of the rewarded pension benefits is less than the minimum pension than these will be fulfilled with the sources of the first state system.

Option 2

First state pillar:

- two types of pensions (invalidity and household) and supplement to minimum pension benefit
- defined benefit
- rate of contribution of 10% gross salary

Fully funded second pillar

- particularly old age pension
- benefit according to defined contributions
- rate of contributions of 10% gross salary

The new system will be compulsory for new entrants and voluntary for the rest of the employees. Voluntary participants will enjoy rights only from the new system. Old age pensions will be rewarded only from the second pillar of the contributions levied on their individual accounts. Household pensions will be remunerated on the principal as the invalidity pensions. If any of the rewarded pension benefits is less than the minimum pension than these will be fulfilled with the sources of the first state system.

The analysis of the options is presented in the tables 4 and 5 in the Annex 2

8.3.2 Evaluation of the proposed options

The debate to date has been on the transformation of the public pension system into two pillars. The institutions governing the reform[175] in the Republic of Macedonia presented the advantages

[175] Ministry of Labour and Social Policy, Pension and Disability Fund in the Republic of Macedonia, the Employment Agency, Ministry of Foreign Affairs, Sector for European Integration, Government of the Republic of

and disadvantages of the proposed options from an individual, and from the pension system and national economy point of view.

The survey included questions on the advantages and disadvantages of the systems, transitional costs, and investment prospective

Advantages of the option 1
Advantages for the Individual:
1. Security
Old age income is remunerated from two sources, and the state endorses the rewards from the first pillar benefits. According to the Government and local Ministries, this would be a plus of the first option since bigger part of the contributions will be state covered, and the other part will be on individual risk and the solvency of the chosen Pension Company. If the public PAYG system is under risk that will not influence liquidity of the funded system and *vice versa.* Only Public Revenue office and the Ministry of Finance stated their concern of maintaining solid financial foundation of the systems and having regard to the budget deficit that is covering benefits in the past several years.
2. Aligning pension benefits and salaries
In both public and capitalised systems pension benefit will be directly connected with salaries and calculated on the pension formula for the first public system, and according to the scale of the contributions invested in the second system.
3. Rates of return
The rate of return on the contributions invested in the first pillar in the long term is equal to the increase in the salaries. The second pillar will provide benefit yield equal to the increase of the average salaries and plus 2% of the sum. Therefore, as the contributions in the second pillar grow future expected pensioner's income increase.
Advantages of the Pension System on the national economy
1. Transitional Costs

Macedonia, State Statistical Office, Public Revenue Office, Ministry of Finance, NGOs and International organisations

Option 1 will have smaller transitional deficit that will proceed for a shorter period (20 years) in relation with the second option where the deficit will increase and will last for over 35 years. All institutions governing the reform opt for a reform that will have less and stable transitional costs, as the vulnerability of the Macedonian economy is still very high.
2. Simplification of the reform
Option 1 will preserve the PAYG system, which will exploit the synergies of the already performed parametrical reforms and will safeguard the economy from the costs and time from the systematic radical reform as in option 2.
3. Critical Investment capital
Greater part of the contributions in the second pillar according to option 2 will form a critical investment capital and in the same time will increase the vulnerability of the system. There is a risk of fiscal shock as a result of the outflow of capital from the PAYG system necessary for financing current pension costs. According to option 1, the critical investment capital will be enough for continuing performance of the private pension funds, and the fiscal shock in the public sector will be less significant.
4. Costs of the system
Calculated on the long run the costs of the reform option 1 will be higher than the second option, with the advantage that this option can provide smaller transitional costs and will finish in shorter time, which would alleviate the process of pension reform.
Disadvantages of the option 1
1. The scope of the public pillar
The main critic on the first pillar within option 1 is the capacity of the public pension system. Although, with the transformation, the capacity has decreased, still bigger part (13%) stays within the Government control and therefore part of the public budget. The influence and meaning of the second private funded pillar is undersized having the lack of utilisation of advantages provided by the fully funded system. However, State Statistical Office of Macedonia argues that the capacity of the PAYG system after reform will be less significant and maintainable on the long run.
2. Less opportunities for Investment

As a possible critic of the first option, Sector for European Integration of the Republic of Macedonia, points to the insufficient resources in the second pillar for investment. The rates of return in the second private funded scheme are higher, therefore the smaller the contributions in this schemes, the trifling the benefits for future pensioners depending on the second scheme. The Macedonian Government also points to the less significant effects of the economy, foreign investments through international pension companies are fundamental for the sustainability of the funded pension system.
3. Costs of the system
Option 1 has a disadvantage in the costs of the reformed system. On the long run, these costs are immeasurable in regards of the second option. Long-term balance rate of the contributions paid in the schemes comprising the first option is higher and gives no opportunities for decreasing the labour costs.
Advantages of the Option 2
Advantages for the Individual
1. Rate of return
The rate of return is in the second scheme is much higher and in the second option, contributions to the second scheme are higher than in the first option. This would imply to advanced benefit rates.
2. Connection between contributions and benefit
Contributions made in the second private funded scheme are entirely individual. This will result with higher confidence in population in the pension system[176], which is one of the biggest concerns within Macedonian Government[177]. Bearing in mind that the contributions in the second scheme are higher than the ones from the first option it can be said that this option is better than the first one.
3. Administrative costs
State Statistical Office argues that as long as the administrative costs are lower, the benefits from the investment will be higher. Introducing the Second pillar will reduce

[176] Communication from the Commission of the Social Agenda, COM/2005/0033 final

[177] People in the Republic of Macedonia have suffered within previous 10 years from loosing their savings due to insolvency of many insurance companies, and are unsatisfied overall in the atrocious performance of the national Social Security policy

these costs on minimum, so individuals will probably prefer to pay their contributions in this scheme, so option 2 will be better choice.
Advantages of the pension system for the national economy
1. Correlation among first and second pillar
The correlation between the two pension schemes within the second option is the biggest advantage. With this option, the system is transformed in a way that gives equal importance of the second pillar in relation to the first. The Ministry of Finance also argues that by the fact that this option predicts more capital flows in the second scheme will decrease the future governmental responsibility (debt) within the first public (PAYG) scheme.
2. Additional positive effects
As previously mentioned, the more contributions are engaged in the second pillar the more investments will occur in the Macedonian economy. The importance of the second scheme is seen through more rapid development of the national capital market. It is of common belief that the bigger the role of the second pension pillar, the higher macroeconomic effects and therefore this option is more acceptable. By dividing equal contributions in both schemes, this option is more capable of attracting new and first-rate investors.
3. Costs of the System
Actuarial projections from the Ministry of Labour and Social policy show that pension system based on the second option will be more economical. Having flat rate of contributions in the long term, part of the excess contributions will be used for financing transitional costs. Long-term balance rate of contributions within the first option does not give these results.
Disadvantages
1. Establishing new principles of working of the Macedonian Pension System
Main critics on the second option are in its foundation, which will remunerate old age pensions only from the second, individual scheme, and the public social security scheme will cover only minimal, invalidity and household pensions. This indicates that the system will experience systematic reform, changing fundamental principals of functioning of the Macedonian Pension system. The main problem by this

transformation is that the state will not govern the old age security pensions, yet the risk of pension benefit is left on the individuals, the investment and the rates of return.
2. Risk Diversification
Second critics of the option 2 is that by utilising this system the risk of the insured is much higher since their old age pension will depend only on the second scheme.
3. Financing the transition
Transition deficit according to this option will be higher then in option 1, it can be hardly covered and will last longer. Ministry of Finance of the Republic of Macedonia states that current fiscal position in the country is not able to bear immense capital outflow from the first (public) pillar and create capital vacuum.
4.Change of legislation
Radical change of the fundamentals of the PAYG system and introducing the second pillar for the old age pensions will provoke an profound change in the pension and social security legislation, which will automatically prolong the reform process.

There are numerous arguments for each of the options, given that both of them provide sustainability on long term. However, preferences are on the side of the first option; with these reforms, system will suffer less in the change of the legislation. The principals of the existing system will remain as they are stated in the Constitution of the Republic of Macedonia, by which all citizens have the right of social security and insurance of all risks (old age, disability and death). The benefit of not further changing legislation is of outmost concern, for both Macedonian Government and the EU. The immediate character of the reforms will provide benefits for the pension funds from genuine access to the Single Market and the single currency and subsequently the EU-wide capital market can better absorb the growth in pension funds and allow for better risk diversification and better rates of return on investments for pension savers, thereby enhance employment and growth.

Furthermore, according to the tables in annex 1 and 2, system option one has more feasible effect on the system finances, which is reasonable having most of individual contributions still in the public scheme. Similarly, second option is desirable in terms of ceasing Government obligations towards old age pensions and therefore lowering the budget deficit built during years.

However, the supreme option for the Republic of Macedonia given the financial foundation of the system, current labour market and transitional costs according to the institutions governing the reform will be Option 1.

9. Conclusion

As indicated in the introduction, pensions are located among top priorities in the Integrating Europe and creating the European Family. Having regard of the new demographic challenges in the EU pension polices must be redesigned in order to serve income security in old age. Governments in Central Eastern and Continental Europe, presented in the paper, created new schemes which reconciled the multiple retirement objectives into “private-public hybrids”[178]

Under the Union’s guidance countries adopt similar strategies, yet, the environment, the problem and the answer develop through different institutional mechanisms by which MS legitimately intervene to achieve common policy goals. Therefore, whether “pay as you go” systems or funded systems will best meet the challenge of new retirement aspect and higher pensions for the elderly[179] is not a question to be answered by the European Social policy. In fact neither European Institutions nor the Member States have a design panacea to fight challenges of pension systems in the long term.

The answer to the growing diversity of pension polices (what is in the MS jurisdiction) is to utilise the concept of "triangle" of mutually reinforcing policies - employment, social protection, and economic and budgetary policy[180]. Only a strong positive interaction between these policies, can guarantee the future ability of pension systems to fulfil their basic social goals. Furthermore if Governments ensure that these polices are coherent, complementary and integrated each MS including countries candidates could set out strategies for ensuring the sustainability of adequate pension provision and modernise their pension systems. Helped by the Commission these strategies will be integrated national strategy reports, which would explain the combination of policy measures through which the common objectives are to be achieved. Countries using the method of cooperation would provide the systems to be as much as possible transparent and provide the necessary data for national demographic characteristics and pension indicators in

[178] Noel Whiteside, “Adapting private pensions to public purposes: historical perspectives on the politics of reform”, University of Warwick, UK

[179] According to Hemming (1998) IMF, there is relatively small interest on the effects of switching from unfunded to funded systems.

[180] As outlined in the European Social Agenda adopted at the Nice summit of December 2000

order for European Union to determine national patterns of reforms and identify good practices and innovative approaches.

Harmonization of national legislation of pension funds is the second imperative, which will improve and support labour mobility and enhance economic growth. While countries prefer to undertake partial system reforms, and as we have seen in the paper, these reforms are constantly under reassessment and review by institutions governing them. Thus, obtaining quality data will improve the system projections and will make system characteristics transparent for beneficiaries; they can easily calculate their 1) income/contributions at present and 2) aggregate benefits for old age. This will secure European citizens from unpredictable government actions towards pension issues and will certainly strengthen their confidence in the national and European social policy.

On the question if there is a paramount strategy, yet, it cannot be said that there is one possible example of well designed pension system since they all develop in different national demographic, economic and social environments. For what is worth, the Commission integrative and cooperative approach will serve as a basis for comparison among different options and polices, providing best and worst practices which in the distant future may point to one or hopefully few polices that will be served as standard social protection in Europe and applicable for both MS and candidate countries.

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<u>**Cases and decisions**</u>

Case C-204/90 Bachmann v. Belgian State

Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation

Council decision 2004/518/EC of 14 June 2004 on the principles, priorities and conditions contained in the European Partnership with the Republic of Macedonia (OJ L 222, 23.6.2004, p. 20).

Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision

Regulation (EEC) No 1408/71 of the Council of 14 June 1971 on the application of social security schemes to employed persons and their families moving within the Community

Law on mandatory fully funded pension insurance 2004, Macedonia

ANNEXES

Annex 1

Table 3. Main parameters of the current public pension systems 1993-2003

Year	Pensioners	Participants	Rate of workers/pensioners	Rate Pension/Salary	Expenses/GDP
1993	210537	509000	2.4	77.50%	16%
1994	216834	496000	2.3	68.90%	12.60%
1995	219307	426861	1.9	64.30%	10.80%
1996	222726	402198	1.8	64.50%	10.7%
1997	227099	379353	1.8	63.60%	10.5%
1998	232216	377551	1.6	59.30%	10.8%
1999	235839	372155	1.6	64%	10.6%
2000	241221	363022	1.5	62.70%	10.6%
2001	247200	351009	1.4	61.70%	10.5%
2002	249421	332729	1.3	60.20%	10.4%
2003	254267	327909	1.3	62.10%	10.9%

Table 4. Fertility rates in Republic of Macedonia

1997	1998	1999	2000	2001	2002
1.92	1.9	1.76	1.88	1.72	1.5

Figure 7. Fertility rates in Republic of Macedonia, projections until 2060

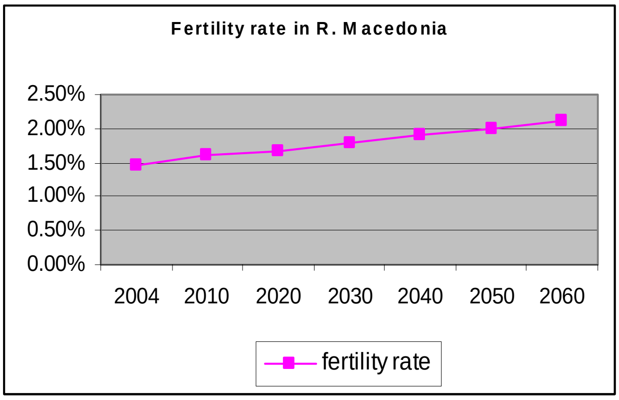
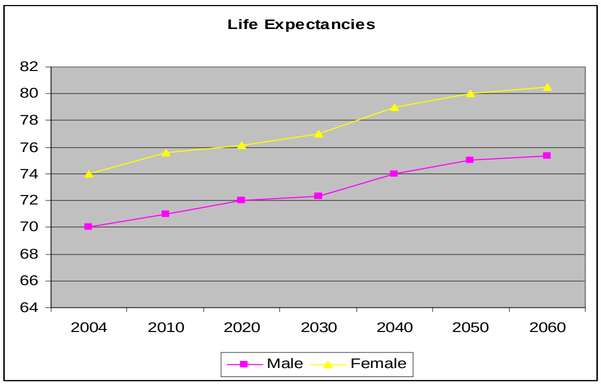


Figure 8. Life expectancies in Republic of Macedonia



ANNEX 2

Table 5: Option 1

Source: Ministry of Labour and Social Policy

Year	Active participants			Pensioners			Contributions from 1st pillar for participants in			Pensions from 1st pillar for participants in			Deficit (Surplus)
	only in 1 pillar	2 pillars	Total	only in 1 pillar	2 pillars	Total	only in 1 pillar	2 pillars	Total	only in 1 pillar	2 pillars	Total	
1998	379130	0	379130	232487	0	232487	7.40%	0.00%	7.40%	8.20%	0.00%	8.20%	-0.80%
2000	219467	168253	387720	228222	4110	232332	4.60%	2.00%	6.60%	8.10%	0.00%	8.10%	-1.50%
2010	119933	375111	495044	227978	11028	239006	2.00%	3.40%	5.40%	5.10%	0.10%	5.20%	0.20%
2020	24131	552137	576268	266005	28668	294673	0.40%	4.50%	4.90%	4.90%	0.30%	5.20%	-0.30%
2030	0	611537	611537	204841	117839	322680	0.00%	4.70%	4.70%	3.00%	1.40%	4.40%	0.40%
2040	0	589668	589668	96793	249344	346137	0.00%	4.70%	4.70%	1.10%	2.50%	3.60%	1.20%
2050	0	561895	561895	24671	349911	374582	0.00%	4.70%	4.70%	0.20%	3.00%	3.20%	1.50%

Table 6: Option 2

Source: Ministry of Labour and Social Policy

Year	Active participants			Pensioners			Contributions from 1st pillar for participants in			Pensions from 1st pillar for participants in			Deficit (Surplus)
	only in 1 pillar	2 pillars	Total	only in 1 pillar	2 pillars	Total	only in 1 pillar	2 pillars	Total	only in 1 pillar	2 pillars	Total	
1998	379130	0	379130	232487	0	232487	7.40%	0.00%	7.40%	8.20%	0.00%	8.20%	-0.80%
2000	271692	116037	387729	230122	2209	232331	5.60%	1.00%	6.60%	8.20%	0.00%	8.20%	-1.50%
2010	176565	318478	495043	231834	7172	239006	2.90%	2.20%	5.10%	5.10%	0.10%	5.20%	-0.10%
2020	60731	515537	576268	274867	19806	294673	0.90%	3.20%	4.10%	4.80%	0.20%	5.00%	-0.90%
2030	0	611537	611537	260352	62329	322681	0.00%	3.70%	3.70%	3.90%	0.40%	4.30%	-0.70%
2040	0	589668	589668	142498	203639	346137	0.00%	3.70%	3.70%	1.70%	0.70%	2.40%	1.30%
2050	0	561895	561895	48062	326519	374581	0.00%	3.60%	3.60%	0.40%	0.60%	1.00%	2.60%

* Data used in the simulations are for the participants and pensioners that stay in the old system and those included in the new system and their contributions as a share of GDP as well as the benefit ratio in GDP. The last column represents the result of the contribution revenues and pension expenditures from the first public system as regards to GDP.