CENTER FOR POLICY STUDIES

ChangingEmployment

DRAGOS ADASCALITEI AND STEFAN DOMONKOS

What really is a pension crisis? A theoretical argument on the link between ageing, productivity, and retirement

2015/7

WORKING PAPER SERIES

ABOUT THE PROJECT

The paper was prepared within the framework of the research project '**The changing nature of employment in Europe in the context of challenges, threats and opportunities for employees and employers (ChangingEmployment)**'. The project runs between 2012-2016 and has received funding from the European Commission's Seventh Framework Program Marie Curie Actions-Networks for Initial Trainings. The research was also financially supported in part by the German Science Foundation (DFG) project DR 827/2-1 'Weathering the crisis?' (PI Jan Drahokoupil) and by the by the Slovak Research and Development Agency (APVV) project APVV-14-0787.

ABOUT THE PAPER SERIES

Working Papers reflect the on-going work of academic staff members and researchers associated with the Center for Policy Studies/CEU. They are intended to facilitate communication between CPS and other researchers on timely issues. They are disseminated to stimulate commentary and policy discussion among an international community of scholars.

ABOUT THE AUTHORS

Dragos Adascalitei is a junior visiting researcher at the CEU Center for Policy Studies and a graduate student at the Graduate School of Economic and Social Sciences at the University of Mannheim. At CEU CPS he is an Early-Stage Researcher of the 'ChangingEmployment' Marie Curie Initial Training Network. His interests are: social security reforms in Eastern Europe, industrial relations, and labor market reforms. His work has been published by Social Policy and Administration, International Social Security Review and Economic and Industrial Democracy.

Stefan Domonkos is a researcher at the Mannheim Centre for European Social Research (MZES) and a graduate student at the Graduate School of Economic and Social Sciences at the University of Mannheim. His research interests are the political economy of pension and tax reforms, including public opinion on these policy areas. Stefan's work has been published by Global Social Policy, the International Journal of Social Welfare and the International Monetary Fund.

TERMS OF USE AND COPYRIGHT

CENTER FOR POLICY STUDIES
CENTRAL EUROPEAN UNIVERSITY
Nádor utca 9, 1051 Budapest, Hungary
http://cps.ceu.edu, cps@ceu.edu

WHAT REALLY IS A PENSION CRISIS?

A THEORETICAL ARGUMENT ON THE LINK BETWEEN AGEING, PRODUCTIVITY, AND RETIREMENT

Dragos Adascalitei and Stefan Domonkos

CONTENTS

ABSTRACT

This paper revisits the arguments put forward by policy-makers about the ongoing crisis of public pension systems. Demographic ageing, high contribution rates, present or future fiscal deficits of the social security budgets, and low productivity levels – all these factors have been identified as the roots of pension crises in various countries. We analyze these conceptualizations of the pension crises in the context of Central and Eastern European political economies. We argue that considering demographic ageing or the fiscal condition of the pension budget akin to a crisis is unwarranted. By contrast, we link the notion of a pension crisis to productivity levels, and subsequently evaluate whether an increase in labor productivity can serve as a solution to the financial strain of public PAYG schemes in Central and Eastern Europe. We find that dependence on foreign direct investments might be a significant hindering factor, and conclude that even sizeable increases in productivity levels might fail to resolve the financing difficulties of public PAYG systems in Central and Eastern Europe. Under these circumstances, austerity, especially increases in the retirement age accompanied by policies of active ageing, appear to be the most acceptable solution to the fiscal problems of exiting PAYG pension systems.

INTRODUCTION

The issue of old-age pension provision has become one of the most prominent social-policy topics in the past decades. Economists, political scientists and sociologists have devoted considerable effort to studying the impact of various pension policies on the national economy, the political processes leading to pension reforms, as well as the social implications of retrenchment in old-age social security. Observing the emphasis put on demographic ageing, a process that is gaining impetus around the world, it appears likely that pension policies will remain in the focus of the social sciences also in the years to come.

This study contributes to the ongoing pension-debate by investigating the link between productivity levels and pension system finances, with a particular emphasis on the impact of dependence on foreign direct investment (FDI) on the political economy of pension reforms. We start by outlining the relationship between labor productivity and old-age pensions. It is commonly accepted in the mainstream pension-economics literature that the adverse effects of an increase in the old-age dependency ratio can, at least partly, be mitigated by growing labor productivity (e.g. Augusztinovics 1999; Barr 2002; Simonovits 2002; Barr and Diamond 2009; Barr 2012). Building on this literature, we argue that public *pay-as-you-go* (PAYG) pension systems enter a genuine fiscal crisis when increases in productivity levels cannot cover current outlays. This is evident in countries whose economies are dependent on FDI. We argue that due to their structural conditions, countries heavily dependent on FDI are likely to profit from labor productivity increases to a limited extent only. Higher wages, increased social-security contributions and higher tax revenues are not easy to come by in an intensifying bidding war to attract FDI. This, in turn, limits the maneuvering space of domestic policy makers, especially when it comes to financing extensive welfare programs such as public PAYG pension systems.

The above argument is discussed in greater detail within the context of the Central and Eastern European countries (CEECs). For the past two decades, these nations have been involved in a fierce competition for FDI. As a consequence, the wage share of labor declined in most CEECs, together with taxes on corporate profit. We argue that labor's declining share in the national product is one of the key factors that contribute to the fiscal crisis of the public PAYG pension systems. If this tendency is to continue further, productivity increases, even if present, are an unlikely solution for the financing difficulties of the public PAYG pension schemes in the CEECs. Thus, austerity in old-age social security appears inevitable, even at high levels of economic growth.

The structure of the paper is as follows. Section one summarizes the most important arguments used in the recent pension discussion in the public policy and social science literatures. Section two discusses the link between labor productivity and public PAYG pension systems. Section three provides an explanation of how FDI dependence might have a long-lasting impact on the political economy of pension reforms. The final section discusses the implications of our argument for the pension systems' reform alternatives that governments in CEECs currently face.

1. DOMINANT DISCOURSES ABOUT THE PENSION CRISIS

Pension crisis is one of the most resonant catchphrases that dominate social policy studies since the mid-1990s. The phrase started its career both in academia and the public policy discourse beginning with the publication of the World Bank's (WB) *Averting the Old Age Crisis* in 1994 (World Bank 1994). In its report, the institution argued that, especially in developing countries, public *pay-as-you-go* (PAYG) pension systems face an impending fiscal crisis due to the pressures stemming from population ageing, the maturation of public PAYG pension systems, high levels of social security coverage in developed countries, easy access to early retirement benefits, already high contribution rates and insufficient increases in national productivity levels (World Bank 1994, 140). The antidote, as the WB famously claimed, is the retrenchment of the public PAYG pension systems to paying minimum flat-rate pensions and the introduction of earnings related benefits to be provided through mandatory savings accounts.

In the WB's view, in the short term, the pension crisis was reflected in the high levels of contributions used to finance benefits for an ever growing population of retirees and in the negative fiscal balances of the social security budgets. WB economists, such as Robert Holzmann, argued that 'even balanced pension schemes create fiscal problems when high contribution requirements crowd out general government revenue, such as income taxes, or soak up debt capacity that would be better used for long-term investment' (Holzmann 2000, 13). Paradoxically, social security contribution rates were thus among the first items to be changed if countries were to avoid a pension crisis. With almost no exceptions, advice given by the WB to Central and Eastern European countries (CEECs) contained recommendations to reduce the rate of contributions and, at the same time, shift the burden of social security taxes towards employees (Andrews and Rashid 1996).

The belief that high payroll taxes were one of the main culprits for the labor market problems that CEECs faced during the transition period, led the institution to advocate for substantive cuts in social security contribution rates. These cuts were assumed to have a positive impact on the revenues of the social security budgets since decreases in the level of contribution rates were believed to help improve the tax collection rates, reduce the informal economy, and ultimately reduce social security deficits. The beneficial impact of lower contribution rates would be augmented by partly shifting them onto private accounts. One of the main aims of privatization was thus to increase the incentives for workers to participate in pension schemes and expand coverage by reducing the flow of workers into the informal sector (Devesa-Carpio and Vidal-Meliá 2002; Edwards and Cox Edwards 2002).

Privatization as a solution to labor-market problems was seen as being particularly important in Central and Eastern Europe (CEE), where tax evasion and participation in the informal sector was easy and there was no predictable link between contributions and benefits provided by the state. Shifting to mandatory private accounts was believed to solve labor market issues by increasing employers' ability to hire workers and 'encourage people to remain in work longer' (Disney and Whitehouse 1999). Highprofile proponents of the pension-privatization agenda in CEE still claim that the reform is badly needed in order to increase incentives for joining the official economy (Bokros 2013), because they forge a strong and well-identifiable link between past contributions and future benefits. In addition, as Brooks (2006) emphasizes, seemingly detaching pension provision from the public budgets was a policy shift welcomed by workers often distrustful of the state. By contrast, it was rarely discussed that the incentives through which pension privatization supposedly increases labor market participation rely on the maintenance, or even exacerbation of social inequalities (see Ebbinghaus and Neugschwender 2011).

For example, in praising Bulgaria for following its advice in passing pension privatization and pension retrenchment reforms, the WB noted in its 2003 country report that the further 'easing of the overall tax burden, especially payroll taxes, is highly desirable to boost employment and reduce tax evasion' (World Bank 2003, 9). Nevertheless, more than a decade after the reform, evidence for the change in pension system coverage that is attributable to the introduction of private accounts in this country points in the opposite direction. Participation in the informal labor market remained high (Wallace and Latcheva 2006) while the social security tax collection did not improve but worsened, which caused the public pension system to run an all-time high fiscal deficit.

Furthermore, the WB argued that, in the long term, the main problem of the public PAYG pension systems is their sensitivity to demographic changes. Low fertility rates and increased life expectancy were argued to amount to a demographic time bomb that is set to explode in the upcoming decades, once baby boomers begin retiring (World Bank 1994; Holzmann 2000; Holzmann, MacKellar, and Rutkowski 2003). Projections of old-age dependency rates and expenditure ratios were used to show that in the long term public PAYG pension systems are likely to become more expensive and thus more dependent on higher levels of taxation. For example, the WB projected that in countries such as the Czech Republic, Poland, and Slovenia the share of elderly (population older than 65) on the total population would rise by 8 per cent by 2025 (Chawla, Betcherman, and Banerji et al. 2007, 6). More generally, in CEECs, the WB argued that population decline will take place at a faster pace in comparison with other countries due to the region's specific demographic legacy and the population decline associated with the transition to a market economy (Chawla, Betcherman, and Banerji et al. 2007).

Importantly, the WB claimed that public PAYG pension systems 'have major effects on labor and its productivity, on capital accumulation and its allocation, on the ability of governments to finance public goods and services - and therefore on the growth of the economy (World Bank 1994, 120). The WB further stated that public schemes financed through payroll taxes hinder the demand side of the labor market, thus making employers less likely to hire new labor force, while also making early retirement and moonlighting more likely. By comparison, a private pension system would have a positive impact on the labor and capital markets as it would 'reduce labor market distortions and accelerate financial market development and promote saving and capital market accumulation' (Castello Branco 1998, 26). However, evidence for the negative economic impact of public PAYG systems is mixed (Beattie and McGillivray 1995; Samwick 1998). At the same time, the impact of private pillars on aggregate saving rates is inconclusive (Barr 2005). Similarly, hopes concerning increased participation in the official economy seem overly optimistic after more than a decade-long experience with funded schemes. As Simonovits (2002; 2011) points out, such expectations are unlikely to materialize in the real economy. After all, declaring income earned in the grey economy does not only go hand-in-hand with the requirement to pay old-age pension contributions, but also general taxes and other payments unrelated to old-age social security. Finally, expectations concerning private schemes' contribution to economic growth also require a re-evaluation, as a large part of the portfolios were invested in government bonds (see Naczyk and Domonkos forthcoming) instead of serving as capital for the domestic economy.

More than a decade later, writing about CEE, the WB itself recognized that 'demographic trends in the region do not inevitably mean problems for the labor market' (Chawla, Betcherman, and Banerji et al. 2007, 15). But probably the most important change in the WB's ideas came with the recognition that 'relatively small changes could lead to much better outcomes' (Schwarz et al. 2014, 259) and that shifting to mandatory savings accounts is a costly strategy that requires additional 'fiscal resources to pay for the transition costs' (Schwarz et al. 2014, 258). These recent conclusions suggest that the WB shifted its focus from dogmatically advocating for the introduction of mandatory savings accounts towards a more nuanced approach that considers adjustments in the parameters of the PAYG systems to be more efficient in dealing with the demographic ageing problem.

The WB's arsenal of arguments gained a significant visibility in academia, where they received implicit acceptance, especially from scholars working on the political economy of pension reforms. For instance, Armeanu (2010, 16) notes that 'a pension crisis may not be manifest, but may be expected in the near future, as indicated by an ageing population and a projected decline in the ratio of contributors to beneficiaries in the pension fund'. In a similar vein, Guardiancich (2013) argues that the different social, economic, and demographic problems that marked the transitions from state to market in CEE, contributed to the deterioration of the fiscal situation of the public PAYG systems, and led to the 'normative de-legitimization of such schemes'. Although he concedes that WB reform proposals have 'doubtful economic advantages' he does not discuss further why this is the case or what the implications of his claim are. Scholars concentrating on Western European processes of pension privatization (e.g. Ebbinghaus and Neugschwender 2011; Ebbinghaus 2015) are also prone to forging a direct link between demographic processes and the financial health of the pension system, often citing the analytical output of the WB.

The explanation for this implicit acceptance of the WB's ideas about pension reform is to be found in the nature of the questions that social policy scholars asked. Most of the political economy literature did not focus on questioning the assumptions that came implicitly with the WB proposals. Instead, scholarly literature devoted more interest to what made possible the introduction of mandatory savings accounts in countries of Latin America and Eastern Europe (Mesa-Lago and Müller 2002; Orenstein 2009a; 2009b). A host of explanations coming from this literature found that the introduction of mandatory private accounts was facilitated by existing fiscal problems in the public systems (Müller 2001), transnational campaigns that efficiently advocated for privatization (Orenstein 2009a), or the coming to power of a pro-reform, liberal center-right coalition of parties (Armeanu 2010). The focus was thus on the outcome of privatizing reforms rather than on the economic rationale that made privatization more desirable in comparison with adjusting and preserving public PAYG pensions systems. Moreover, very little space was devoted to discussing what productivity means to the stability of existing pension systems despite the fact that variation in productivity levels may play a more important role for the fiscal stability of the pension systems than demographic processes. Once productivity assumes its proper place in the theoretical discussion on pension crisis, it will be possible to evaluate if the WB proposals fit the political economies of CEE.

2. WHAT IS A GENUINE PENSION CRISIS

2.1. Public discourse in the light of pension economics

In the previous sections, we have provided a brief discussion of how the pension crisis is commonly conceptualized in the international debate about policy reforms and how this was reflected in academia. As the examples have shown, the pension crisis-discourse revolves around the deficit of the public PAYG system or of the social security system as a whole, too high contributions, demographic adversity and productivity. Nevertheless, when analyzing the sustainability of pension systems in CEECs, the literature has so far neglected the importance of FDI-reliance. This structural-economic factor is likely to be a significant constraint in the politics of pension provision. While, the deficit of the social security system and demographic adversity are all conditions worthy of mentioning when discussing pension provision, they are not particularly helpful in exploring the roots of the problem.

Firstly, while the deficit of the social security system and high contributions are a common symptom of a pension crisis, they are not equal to the crisis as such. In fact, there may be a multitude of causes that might lead to high deficits in the social security system, or require governments to levy high social security contributions on declared income. Insufficient funding of the social security system may stem from the state bureaucracy's inability to collect tax revenue and social security contributions efficiently enough. Moreover, the necessity to levy high taxes and social security contributions on declared income is often a direct consequence of low bureaucratic capacity. If the bureaucratic apparatus of the state is not efficient in rounding up the grey economy, then the taxes levied on income honestly declared by taxpayers need to be increased. The preconditions for bureaucratic weakness in revenue collection were to a large extent given by the state-socialist legacy. Easter (2002) emphasizes that, while state socialist bureaucracies had a rather elaborate system of taxing state-owned firms, their administrative know-how was of limited relevance in the new market economy. This may be particularly true for extracting social security contributions in an environment ever more dominated by atypical labor contracts, a phenomenon becoming apparent across the CEECs (Gebel 2008). Moreover, wide-spread corruption further undermines tax subjects' willingness to join the official economy (Johnson et al. 2000) as well as the state's capacity to extract revenue.

Secondly, deficits and surpluses in the social security sub-account of the general budget are easily influenced by political decisions about the technicalities of revenue collection. The Czech fiscal reform carried out by Mirek Topolánek's center-right government in 2008 demonstrates that social-security deficit is a rather malleable social construct. In 2008, the Czech government was discussing a decrease in the income tax from 15 per cent to 12.5 per cent (Týden.cz 2008). Instead, as a result of political negotiations, it was the social security contributions that were decreased from 34 per cent to 31.5 per cent, thus raising the deficit of the social security system. This increase in the perceived social security deficit was later used to justify the re-opening of the debate on the introduction of a mandatory private funded pillar into the Czech pension system, and allowing a partial opt-out from the state-run PAYG scheme.

Thirdly, demographic adversity is neither a necessary, nor a sufficient condition for a pension crisis to occur. Changing demographic conditions, especially increases in the share of the elderly population of the total population may lead to a pension crisis, if the aggregate output of the national economy suffers due to them. Demographic ageing incites a pension crisis if and only if it causes a decline in the aggregate output. This is not to say that a decrease in the number of workers and/or a rising number of pensioners does not lead to a financial strain in the pension system. However, as long as demographic ageing does not cause a decline in the aggregate output, considering the rising deficit of the social security system, even if occurring concomitantly with a growing old-age dependency ratio, to be an unequivocal evidence of an impending pension crisis is, yet again, unwarranted. For instance, an increase in the productivity of the labor force can offset the negative effect of a shrinking workforce on aggregate output. At least in theory, this should allow the state to finance its public PAYG pension system with much less difficulty than the demographic doomsday scenarios would assume.

However, in economies strongly relying on FDI, there is another issue that requires careful evaluation. Low wage levels constitute an essential part of competition for FDI (Bohle and Greskovits 2012). This orientation of the national economy has its bearing on social security policy as well. If wages are low, the functioning of the PAYG pension system will require increased contribution rates, assuming the government is committed to providing pensioners with a living income. Finally, the two afore-mentioned factors, i.e. low bureaucratic capacity and the use of low wages in the competition for FDI, are often present simultaneously. This indicates that considering a crisis in the financing of the PAYG pillar equal to a genuine pension crisis is not warranted.

The above discussion of the financing of the social security system, demographic ageing and pension crisis has shown that the current state of the public discourse on pensions is overly simplistic. What is missing is a clear linkage between the notions of pension crisis, economic productivity and how productivity increases are reflected in a society. As mainstream pension economics has already shown (e.g. Barr 2012; Barr and Diamond 2006; 2009), the two concepts are intimately connected. Exploring this connection in greater detail allows a deeper understanding of why, what at first sight appears to be a pension crisis, is often better understood as a crisis of state capacity or the consequence of foreign investment driven development of the national economy.

2.2. Labor productivity, wages and the social security system

A basic tenet of the pension-economics literature is that the pension system is a mechanism allowing intergenerational redistribution within the national economy (e.g. Barr 2012). The pre-working-age, the working-age and the elderly population have each their share of aggregate consumption. Distribution towards the pre-working age population takes place in the family, while the elderly typically rely on the national pension system. This might be organized as a PAYG scheme, a fully-funded system, or a combination of the two. While the discussion about the technicalities of organizing the pension system has received a lot of attention in the past two decades, much less has been said about the importance of productivity. This is a considerable weakness of the ongoing pension debate in the political-economy literature: the knife used for cutting the pie seems more important than the size and quality of the pie itself.

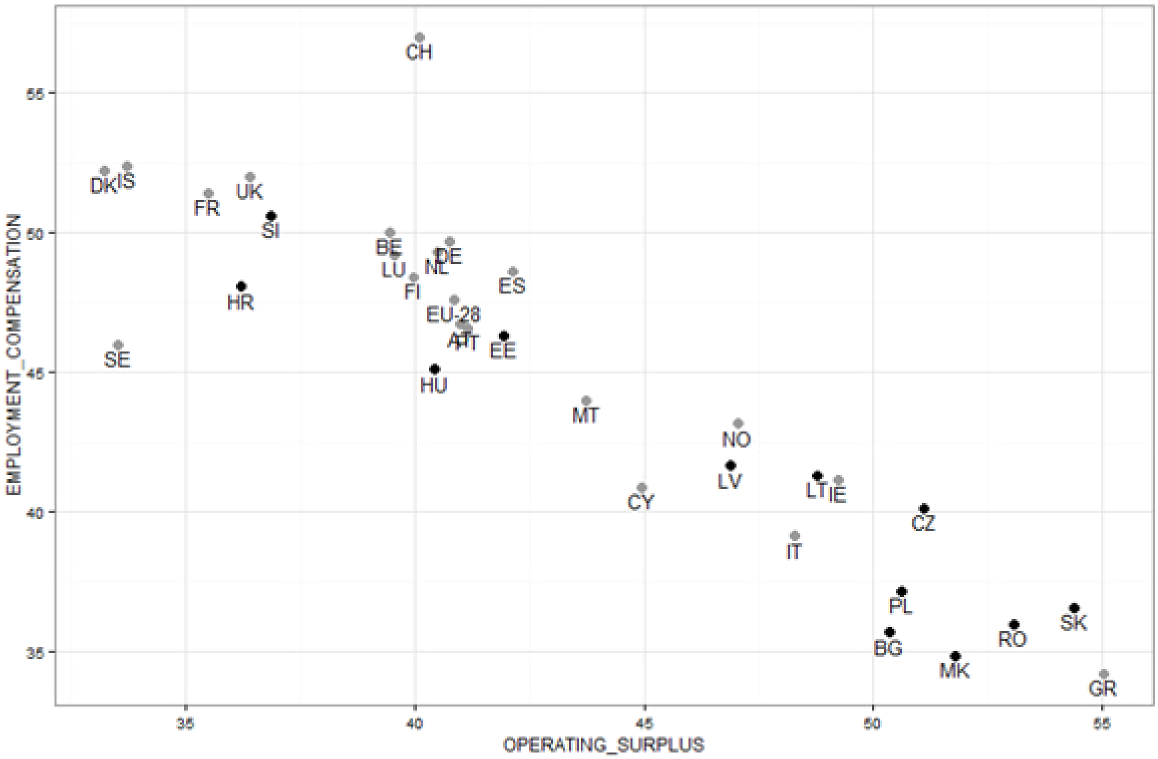
The discussion on demographic processes and their relation to the pension system in sub-section 2 has already provided a hint why labor productivity is of key importance for the national pension system. If less labor input is able to produce the same amount of output, the amount to be distributed between generations remains also the same. If this is the case, a PAYG pension system should not suffer due to demographic ageing. In theory, this should hold even if the only source of revenue for the PAYG social security scheme is social security contributions levied by the state on wages. According to the marginal productivity theory of wages, wages are to increase with increasing productivity. Therefore, the aggregate wage bill of the economically active population should be large enough to allow social security to collect revenue needed for pensions.

An empirically relevant explanation of the importance of workers' income for the social security system is provided by Eisner (1997), in his discussion of the financing of U.S. social security. Eisner (1997) argues that the financing difficulties of U.S. social security, stemming from the projected increase in the dependency ratio will have to be covered by higher taxes on income. A percentage change in net income per capita of -14.2 relative to the 1995-level would be needed to keep the social security budget balanced up to 2075 (see Table 4.1 on p. 50 in Eisner 1997). In other words, workers should accept to put up with 14.2 per cent less disposable income, and so should pensioners. In practice, this calculation implies that taxes for the economically active should increase substantially, while the old-age pension replacement rate should decrease in order to keep the social security budget in balance. However, if we also assume that productivity increases lead to a yearly increase in the net income of just one per cent, the income of an average worker in 2075 should be 121.7 per cent higher than the income of an average worker in 1995. Giving up 14.2 per cent from this amount still leaves an average worker in 2075 significantly better off than his peer from 1995. In a similar vein, while ageing may require future pensioners to accept a lower replacement rate, the real value of their pensions may still be larger than that of cohorts retiring in times when demographic pressures were barely felt, but labor productivity was lower.

However, as a number of empirical studies have shown (e.g. Harrison 2005; Jayadev 2007), the wage share of aggregate output is heavily influenced by a number of factors, capital account openness and capital intensity included. Jayadev (2007) demonstrates that, in high- and middle-income nations, capital account openness has a negative impact on the share of labor's wages on output. The reasons for this are to be found primarily in the weakened bargaining position of labor vis-á-vis an ever more mobile capital. Empirical evidence in this line is also provided by Guscina (2006), who finds that economic openness and a weaker bargaining power of labor lead to decreasing income and compensation shares. Furthermore, Harrison's (2005) enquiry into this question has shown that it is especially workers in less capital-intensive production who are likely to have a smaller wage share on the output produced.

In the FDI-dependent economies of CEE, wage levels are likely to be negatively influenced by reliance on capital from abroad. Dependence on ever more mobile capital will keep the wage share on the aggregate output low, while the profit share will soar. A crude cross-country comparison provided in Figure 1 indeed shows that Europe appears divided with respect to these two macro-variables. The share of employees' compensation on the output in the overwhelming majority of old EU-member countries is above forty-five per cent, in some cases significantly exceeding this benchmark. By contrast, in CEECs, the share of employees' compensation on the output reaches values closer to thirty-five per cent.

Figure 1: Employers' compensation and profit shares of output as a % of GDP, CEECs and EU15 compared (average 2004-2013)



Note: AT=Austria, BE=Belgium, BG=Bulgaria, CY=Cyprus, CZ=Czech Republic, DE=Germany, DK=Denmark, EE=Estonia, FI=Finland, FR=France, GR= Greece, HU=Hungary, HR=Croatia, IE=Ireland, IS=Iceland, IT=Italy, LU=Luxemburg, LT= Lithuania, LV=Latvia, MT=Malta, MK=Macedonia, NL=Netherlands, PL=Poland, PT=Portugal, RO=Romania, SE=Sweden, SI=Slovenia, SK=Slovakia, UK=United Kingdom.

Source: Eurostat database, http://ec.europa.eu/eurostat/data/database, series nama_10_gdp.

The share of corporate profit on the GDP also shows a rather clear tendency to differ between the old EU member states and CEECs. Gross operating surplus and mixed income[1] constitute a larger share of the GDP in CEECs than in Western Europe. The share of profit on aggregate output in Eastern European economies generally reaches values close to or above fifty per cent. The same indicator for Western European economies is most commonly between thirty-five and forty-five per cent.

This trend has two consequences. To begin with, as social security sub-accounts of the state budget in European countries rely most commonly on contributions based on salaries and wages, a lower wage share on aggregate output automatically leads to lower revenue being collected within the social security system, while there is a somewhat larger tax base for corporate taxes. The wealth generated by workers that is subsequently transformed into corporate profit rarely enters the base for social security contributions into the PAYG social security system.

1 According to the definition of the Eurostat (2013), the gross operating surplus is the excess amount of money that is earned by the enterprise once labor costs are subtracted. Mixed income means the type of income generated by unincorporated enterprises (e.g. small farmers), where the income generated by capital and labor cannot be clearly distinguished.

Furthermore, the transformation of aggregate output into profit also means there is more tax to collect using corporate and personal income taxation. Thus, the general state budget suffers somewhat less due to the trend of rising profit shares and declining wage shares of aggregate output than does the social security system. Nevertheless, dominant views in pension politics often ignore these circumstances. The necessity to transfer money from the general state budget into social security system is often argued to be a clear evidence for a pension crisis. Little attention is paid to the fact that this is not the consequence of declining gross domestic product, but rather a structural problem of an economy in which the share of wages on the aggregate product is low. Low wages in turn lead to the lack of sufficient funding for the social security system.

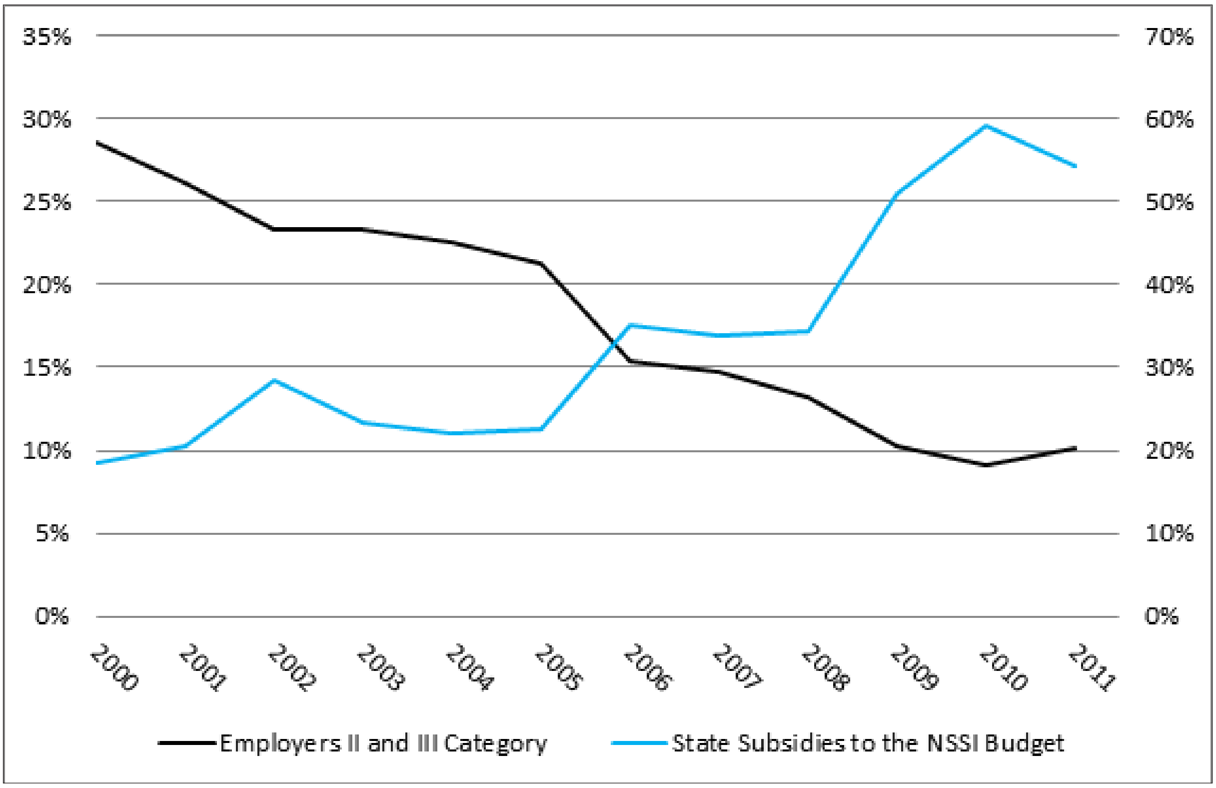
3. THE POLITICAL IMPLICATIONS OF FDI-DEPENDENCE FOR THE PENSION SYSTEM

The above discussion shows that it is not sufficient to concentrate on productivity gains as a source of financing pension expenditures but that we have to consider how these gains are divided into wages and corporate profits. In this section, we turn to the political implications of FDI-dependence for the pension systems. We ask how CEE governments are coping with the pension crisis and what repertoire of reforms they used in order to solve it. We argue that, given the weak bureaucratic capacity and the hunger for FDI, in CEECs, there is only a limited space for governments to pass reforms that will solve the crisis of pensions in the long term. In this respect, parametric adjustments in the public PAYG pension systems, such as cuts in the contribution rates or shifting the burden of contributions towards employees have been used in order to make the pension systems more 'employer friendly'. Given these restrictions faced by CEE governments, it is not a surprise that Western-like reforms which seek to transform the old welfare states into social investment states (Morel, Palier, and Palme 2012; Hemerijck 2013) are unlikely to receive support. A simple comparison of statistical data on expenditure on active labor market policies (ALMPs) between East and West reveals a divided continent.

Intra-regional competition for FDI translated into considerable pressures to reduce tax rates. First, as Bohle and Greskovits (2012) point out, the manufacturing miracles of the CEECs have been accompanied by a tough bidding war between the regional leaders in FDI attraction. The corporate tax rate of Poland fell by ten percentage points, from forty per cent to thirty per cent between 1989 and 2000. Parallel to this process, personal income taxes were increased (Bohle and Greskovits 2012). Cass (2007) provides further detail on the practices of FDI-attraction in the region. In 2005, 87 per cent of the CEECs were offering tax holidays to FDI and sixty per cent provided some type of grant. This shows that the bidding war for FDI is not a passing phenomenon typical for early transition years. In fact, Cass (2007) concludes that competition among the region's countries is becoming more intense over time. In line with these processes, wage increases have been lagging behind productivity increases. In fact, some of the strategic documents endorsed by CEE governments and the public statements of leading politicians (e.g. Slovak Academy of Sciences-Institute of Economics 2008; Government of Romania 2014) reveal that low wages are still seen as an important competitive advantage. This implies that using wage competition in order to attract FDI might remain an option also into the long-term future. In congruence with this view, according to Eurostat data, the per-hour labor costs in Slovakia, one of the region's leaders in FDI attraction, were approximately ten euros in 2014 as opposed to the 25-euro average in the EU-27. Thus, the hourly costs of employing a worker in Slovakia, wages, taxes and social-security contributions included, reached about forty per cent of the EU-wide average. In the meantime productivity per hour worked reached approximately 76 per cent of the EU average (data for 2013), indicating a considerable gap between workers' productivity and the wage they receive.[2]

Second, and closely related to the previous point, the social security programs of CEE competition states have been transformed in order to fit the needs of the employers. This process has been particularly visible in Bulgaria, where employers' social security contributions were cut from 28.6 per cent to 10.1 per cent in the 1999-2010 period, while the deficit of the social security system gradually soared. The reasoning behind this dramatic cut in the social security contribution rates was exactly that the country needs to become more attractive for foreign investors (Tafradjiyski et al., 2002). Furthermore, the hope was that the decrease in social security contributions will automatically improve tax receipts by giving employers an incentive to move out from the grey economy. As naïve as it might seem, this policy direction received considerable support from the WB whose influence in Bulgarian pension reforms grew significantly after the economic crisis of the late 90s.

Figure 2: Changes in Contribution rates by status (left axis) and State Subsidies to the Social Protection Budget (right axis) in Bulgaria: 2000 - 2011



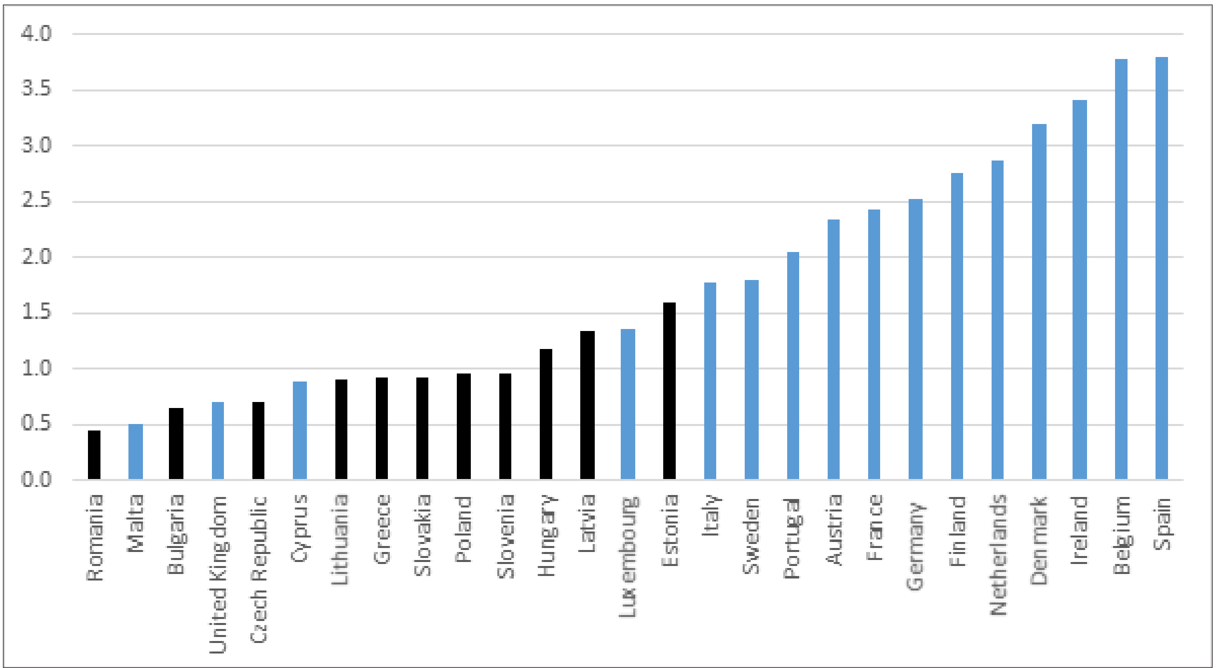
Source: National Social Security Institute of Bulgaria (http://www.nssi.bg).

2 For more details, see Eurostat database, http://ec.europa.eu/eurostat/data/database, series nama_aux_lp on labor productivity and Eurostat (2015) on wages and labor costs.

As Figure 2 shows, the decrease in the social security contribution rates has had an enormous budgetary impact. No less than 60 per cent of the social security outlays were financed through budgetary subsidies in 2010. In response to this crisis, the conservative Borisov government passed a pension reform package in 2011 that increased the contribution rates by 1.8 percentage points– a change that is unlikely to have a considerable impact on the social security deficit. Other changes led to austerity in the pension system by introducing higher retirement ages for both men and women and longer contributory periods for obtaining full benefits. The reform has therefore focused on measures that seek to improve the sustainability of the pension system at the expense of benefit adequacy.

Thirdly, because both employers and governments perceive the welfare state as a cost that hinders economic growth, measures that promote social investment (ALMPs, active ageing, lifelong learning) are unlikely to receive political support in CEECs. Indeed, as Figure 3 shows, total expenditure on labor market policies in CEECs is much lower in comparison with Western Europe. Moreover, despite the fact that the WB, has recently shifted its focus towards a social investment view concerning older workers (Schwarz et al. 2014) this ideational shift had little impact on the political discourses about pension reforms in CEECs. On the contrary, as the crisis hit these economies, the repertoire of possible solutions was quickly reduced to austerity measures.

Figure 3: Total expenditure on LMPs in 2009 (% of GDP)



Source: Eurostat database: http://ec.europa.eu/eurostat/data/database, series lmp_ind_exp.

Empirical evidence on employers' strategies towards older workers shows that in CEECs, companies prefer to 'push' older workers out of the labor market as a strategy to cut labor costs. As a recent case study by Perek-Białas and Turek (2012) has shown, relatively more advanced CEECs, such as Poland, are no exception from this.. In this particular case, the tendency to get rid of older workers might have its roots in Poland's decade-long tradition of reliance on early retirement policies instead of meaningful productive integration into the labor market (e.g. Vanhuysse 2006). Nevertheless, this approach to elderly workers is becoming untenable, as Polish policy-makers have been gradually removing the major early exit options from the pension system, and incorporating sizeable incentives for a longer working life (Chłoń-Domińczak 2009). The Active Ageing Index, a joint project of the European Commission and the United Nations Economic Commission for Europe (Zaidi et al. 2013), indicates that lagging behind in the provision of policies appropriately addressing the ageing of the labor force is typical for the CEECs as a whole. Importantly, it is not only the current situation in which the CEECs seem to be behind the West. There appears to be a general lack of favorable conditions enabling active ageing. The CEECs generally received a very negative evaluation on the "Capacity and enabling environment" dimension of the index. In fact, Poland, Hungary, Slovakia, Latvia and Romania assumed the last five places out of all 27 EU member states (Zaidi et al. 2013).

CONCLUSIONS

In this paper, we argued that the root of the crisis of public pension systems lies in whether productivity increases can cover pension outlays. Due to specific structural condions, especially their reliance on FDI, capital openness and weak labor, CEECs have a limited ability to attain shares in productivity increases. We contended that because of the region's distinct variety of integrating into world markets, productivity increases are not necessarily reflected into wage increases, which creates problems for the pension system if benefits are not to be reduced to merely cover poverty levels. The paper also shows that the dominating international discourses about pension reform alternatives have shifted over the past twenty years from an adamant advocacy for mandatory private accounts towards recognizing that 'parametric' reforms might be a more suited solution for solving the problems that public PAYG pension systems face.

However, even if the WB nowadays seems to have shifted its discourse about pension reforms, it is not clear in which direction its preferences for pension reform will sway. Some argue that post-crisis pension reforms will lead to a 'rebirth' of the privatization paradigm comprising new sets of policies such as funded minimum pensions, notional defined contributions or quasi-mandatory occupational pensions (Orenstein 2011). This move towards individualization through alternative paths seems to be plausible, especially if we factor in the bias against anything state run in CEECs. Nevertheless, much of the debate on defined-benefit, defined-contribution and notional-defined contribution schemes appears as an obfuscation of the more substantial issue related to FDI, wage levels and their implications for the political economy of pension reforms in the CEECs.

Besides, the CEE governments have the option of passing politically sensitive reforms such as increases in the retirement ages or financing public PAYG outlays from the general budget – a trend that is especially visible in the less advanced transition economies. Increases in retirement ages have been already legislated in most of the CEECs in spite of opposition from workers. In this sense, the recent crisis provided a momentum for retrenching public pension systems through the usage of the same 'coercive' policy measures that dominate the pension reform agenda ever since the beginning of the transition. Yet, as we outlined in the sections above, their fiscal impact might be minimal in the absence of a capable state.

Also, as we argued in the previous sections, the discussion about ageing in CEECs misses one important issue, which is the bias of employers against older workers. To some degree, this bias was fed by the liberalization of early retirement policies that were passed in several CEECs in the 1990s. As this approach becomes unsustainable, governments in the region might attempt to persuade employers to alter their attitude towards older workers. Nevertheless, the data suggest that, until now, investment in public policies to do so has been rather limited.

The developmental model followed by the CEECs in the past decades, that is characterized by reliance on FDI, and thus increasing competition for attracting such investment, has influenced significantly the social-policy reforms these countries undertook. However, probably more importantly, FDI-reliance appears to have dire consequences for social policy, pensions included, also in the long-run, as it locks nations in a low−pay−low−pension state. Therefore, developing other comparative advantage than just low labor costs is crucial for increasing the ability of CEECs to address the challenge of demographic ageing.

REFERENCES

Andrews, Emily S., and Mansoora Rashid. 1996. The Financing of Pension Systems in Central and Eastern Europe: An Overview of Major Trends and Their Determinants, 1990-1993. Washington, D.C.: The World Bank.

Armeanu, Oana I. 2010. The Politics of Pension Reform in Central and Eastern Europe: Political Parties, Coalitions, and Policies. Basingstoke: Palgrave Macmillan.

Augusztinovics Mária. 1999. 'A nyugdíj probléma demográfiai és gazdasági alapjai [The Demographic and Economic Backgrounds of the Pension Problem]'. *Demográfia* 42 (1-2): 120–32.

Barr, Nicholas. 2002. 'Reforming Pensions: Myths, Truths, and Policy Choices'. *International Social Security Review* 55 (2): 3–36.

———(ed.). 2005. Labor Markets and Social Policy in Central and Eastern Europe: The Accession and Beyond. Washington, D.C.: The World Bank.

———. 2012. Economics of the Welfare State. Oxford: Oxford University Press.

Barr, Nicholas, and Peter Diamond. 2006. 'The Economics of Pensions'. *Oxford Review of Economic Policy* 22 (1): 15–39.

———. 2009. 'Reforming Pensions: Principles, Analytical Errors and Policy Directions'. *International Social Security Review* 62 (2): 5–29.

Beattie, Roger, and Warren McGillivray. 1995. 'A Risky Strategy: Reflections on the World Bank Report Averting the Old Age Crisis'. *International Social Security Review* 48 (3-4): 5–22.

Bohle, Dorothee, and Béla Greskovits. 2012. Capitalist Diversity on Europe's Periphery. Ithaca: Cornell University Press.

Bokros, Lajos. 2013. Accidental Occidental: Economics and Culture of Transition in Mitteleuropa, the Baltic and the Balkan Area. Budapest and New York: CEU Press.

Brooks, Sarah M. 2006. 'Institutional Legacies in Post-Communist Pension Reform: Global Perspectives and Prospects for Consolidation'. Paper prepared for the Conference on Post-Communist Political Economy and Democracy 2006 at the Comparative Politics Workshop at Duke University, Department of Political Science, April 7-8, 2006. https://www.academia.edu/1002158/Institutional_Legacies_in_Post-Communist_Pension_Reform_Global_Perspectives_and_Prospects_for_Consolidation.

Cass, Fergus. 2007. 'Attracting FDI to Transition Countries: The Use of Incentives and Promotion Agencies'. *Transnational Corporations* 16 (2): 77–122.

Castello Branco, Marta de. 1998. Pension Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union (BRO). International Monetary Fund Working Paper WP/98/11. Washington, D.C.: International Monetary Fund.

Chawla, Mukesh, Gordon Betcherman, Arup Banerji, Anne M. Bakilana, Csaba Feher, Michael Mertaugh, Maria Laura Sanchez Puerta, Anita M. Schwarz, Lars Sondergaard, and Andrew Burns. 2007. From Red to Gray: The 'Third Transition' of Aging Populations in Eastern Europe and the Former Soviet Union. Washington, D.C.: The World Bank.

Chłoń-Domińczak, Agnieszka. 2009. Retirement Behaviour in Poland and the Potential Impact of Pension System Changes. ENEPRI Research Report No. 63. http://www.ceps.eu/book/retirement-behaviour-poland-and-potential-impact-pension-system-changes.

Devesa-Carpio, José E., and Carlos Vidal-Meliá. 2002. The Reformed Pension Systems in Latin America. World Bank Social Protection Discussion Paper 0209. Washington, D.C.: The World Bank.

Disney, Richard, and Edward Whitehouse. 1999. Pension Plans and Retirement Incentives. World Bank Social Protection Discussion Paper 9924. Washington, D.C.: The World Bank.

Edwards, Sebastian, and Alejandra Cox Edwards. 2002. Social Security Privatization Reform and Labor Markets: The Case of Chile. NBER Working Paper 8924. http://www.nber.org/papers/w8924.

Easter, Gerald M. 2002. 'Politics of Revenue Extraction in Post-Communist States: Poland and Russia Compared'. *Political Theory* 30 (4): 599–627.

Ebbinghaus, Bernhard. 2015. 'The Privatization and Marketization of Pensions in Europe: A Double Transformation Facing the Crisis'. *European Policy Analysis* 1 (1): 56–73.

Ebbinghaus, Bernhard, and Jörg Neugschwender. 2011. 'The Public–Private Pension Mix and Old Age Income Inequality in Europe'. In *The Varieties of Pension Governance: Pension Privatization in Europe*, edited by Bernhard Ebbinghaus, 384-422. Oxford: Oxford University Press.

Eisner, Robert. 1997. The Great Deficit Scares: The Federal Budget, Trade, and Social Security. New York: The Century Foundation Press.

Eurostat. 2013. 'Eurostat Glossary of Terms: Gross Operating Surplus (GOS)'. http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Glossary:Gross_mixed_income.

———. 2015. 'Wages and Labour Costs'. http://ec.europa.eu/eurostat/statistics-explained/index.php/Wages_and_labour_costs

Gebel, Michael. 2008. 'Labour Markets in Central and Eastern Europe'. In *Europe Enlarged: A Handbook of Education, Labour and Welfare Regimes in Central and Eastern Europe*, edited by Irena Kogan, Michael Gebel, and Clemens Noelke, 35–62. Bristol: The PolicyPress.

Government of Romania. 2014. Primul-Ministru Victor Ponta S-a Întâlnit Astăzi, La Palatul Administrativ Din Pitești, Cu Reprezentanții Conducerii Dacia-Renault [Prime Minister Victor Ponta Met Today the Representatives of Dacia-Renault in the Administrative Palace in Pitesti]', March 20. http://gov.ro/ro/stiri/primul-ministru-victor-ponta-s-a-intalnit-astazi-la-palatul-administrativ-din-pite-ti-cu-reprezentantii-conducerii-dacia-renault&page=4.

Guardiancich, Igor. 2013. Pension Reforms in Central, Eastern and Southeastern Europe: From Post-Socialist Transition to the Global Financial Crisis. Abingdon: Routledge.

Guscina, Anastasia. 2006. Effects of Globalization on Labor's Share in National Income. International Monetary Fund Working Paper WP/06/294. Washington, D.C.: International Monetary Fund.

Harrison, Ann E. 2005. Has Globalization Eroded Labor's Share? Some Cross-Country Evidence. MPRA Paper No. 39649. http://mpra.ub.uni-muenchen.de/39649/1/MPRA_paper_39649.pdf

Hemerijck, Anton. 2013. Changing Welfare States. Oxford: Oxford University Press.

Holzmann, Robert. 2000. 'The World Bank Approach to Pension Reform'. *International Social Security Review* 53 (1): 11–34.

Holzmann, Robert, Landis MacKellar, and Michal Rutkowski. 2003. Accelerating the European Pension Reform Agenda: Need, Progress, and Conceptual Underpinnings. In *Pension Reform in Europe: Process and Progress*, edited by Robert Holzmann, Mitchell Orenstein, and Michal Rutkowski, 1–46. Washington, D.C.: The World Bank.

Jayadev, Arjun. 2007. 'Capital Account Openness and the Labour Share of Income'. *Cambridge Journal of Economics* 31 (3): 423–43.

Johnson, Simon, Daniel Kaufmann, John McMillan, and Christopher Woodruff. 2000. Why Do Firms Hide? Bribes and Unofficial Activity after Communism. *Journal of Public Economics* 76(3): 495–520.

Mesa-Lago, Carmelo, and Katharina Müller. 2002. The Politics of Pension Reform in Latin America. *Journal of Latin American Studies* 34 (3): 687–715.

Morel, Nathalie, Bruno Palier, and Joakim Palme. 2012. Towards a Social Investment Welfare State?: Ideas, Policies and Challenges. Bristol and Chicago: The Policy Press.

Müller, Katharina. 2001. The Political Economy of Pension Reform in Eastern Europe. *International Social Security Review* 54 (2-3): 57–79.

Naczyk, Marek, and Stefan Domonkos. forthcoming.'The Financial Crisis and Varieties of Pension Privatization Reversals in Eastern Europe'. *Governance*.

Orenstein, Mitchell A. 2009a. Privatizing Pensions: The Transnational Campaign for Social Security Reform. Princeton and Oxford: Princeton University Press.

———. (ed). 2009b. Pensions, Social Security, and the Privatization of Risk. New York: Columbia University Press.

———. 2011. Pension Privatization in Crisis: Death or Rebirth of a Global Policy Trend? *International Social Security Review* 64 (3): 65–80.

Perek-Białas, Jolanta, and Konrad Turek. 2012. 'Organisation-Level Policy towards Older Workers in Poland'. *International Journal of Social Welfare* 21(1): 101–116.

Samwick, Andrew A. 1998. New Evidence on Pensions, Social Security, and the Timing of Retirement'. *Journal of Public Economics* 70 (2): 207–36.

Schwarz, Anita M., Omar S. Arias, Asta Zviniene, Heinz P. Rudolph, Sebastian Eckardt, Johannes Koettl, Herwig Immervoll, and Miglena Abels. 2014. The Inverting Pyramid: Pension Systems Facing Demographic Challenges in Europe and Central Asia. Washington, D.C.: The World Bank.

Simonovits, András. 2002. Nyugdíjrendszerek: Tények És Modellek [Pension Systems: Facts and Models]. Budapest: Typotex.

———. 2011. The Mandatory Private Pension Pillar in Hungary: An Obituary. *International Social Security Review* 64 (3): 81–98.

Slovak Academy of Sciences-Institute of Economics. 2008. Dlhodobá Vízia Rozvoja Slovenskej Spoločnosti [A Long-Term Vision of the Development of Slovak Society]. http://www.akademickyrepozitar.sk/sk/repozitar/dlhodoba-vizia-rozvoja-slovenskej-spolocnosti.pdf

Tafradjiyski, Borislav, Pobeda Loukanova, George Shopov, and Dochka Staykova. 2002. The Pension Reform in Bulgaria – Two Years after the Start. International Workshop Population, Labor Market, Pension and Quality of Life in Transitional Countries.

Týden.cz. 2008. Senát Schválil Snížení Odvodů, Lidé Ušetří Pár Set [Senate Passed Decrease in Social Security Contributions, People Are to Save a Few Hundreds], December 18. http://www.tyden.cz/rubriky/domaci/politika/senat-schvalil-snizeni-odvodu-lide-usetri-par-set_96610.html.

Vanhuysse, Pieter. 2006. Divide and Pacify: Strategic Social Policies and Political Protests in Post-Communist Democracies.Budapest: Central European University Press.

Wallace, Claire, and Rossalina Latcheva. 2006. Economic Transformation Outside the Law: Corruption, Trust in Public Institutions and the Informal Economy in Transition Countries of Central and Eastern Europe. *Europe-Asia Studies* 58 (1): 81–102.

World Bank. 1994. Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth. New York: Oxford University Press.

———. 2003. Bulgaria: Public Expenditure Issues and Directions for Reform. Washington, D.C.: The World Bank.

Zaidi, Ashgar, Katrin Gasior, Maria M. Hofmacher, Orsolya Lelkes, Bernd Marin, Ricardo Rodrigues, Andrea Schmidt, Pieter Vanhuysse, and Eszter Zolyomi. 2013. Active Ageing Index 2012: Concept, Methodology and Final Result'. Vienna: European Centre.