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Institutional Degeneration
of Multipillar Pension Systems
The Case of Croatia

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Abstract

Recent advances in institutionalist theory showed how a rigid dichotomy between typically path-dependent incremental adaptation and radical transformation fails to capture important transformative processes common to advanced political economies. Consequently, a vast uncharted territory opened up and needs to be explored. This paper fills part of this gap by analysing processes where institutional rules and practice show a high degree of resilience in spite of structural reforms. The essay proposes the concept of ‘institutional degeneration’ to capture a situation where structural transformation takes place, but where, in practice, the old institutional structures ‘contaminate’ the new institutional arrangements, thereby enabling the coexistence of old and new logics of action. The argument is empirically sustained through the investigation of the Croatian pension reform, which due to and in spite of its technically almost impeccable implementation embodies a critical example of degeneration amid comparable cases in Eastern Europe and Latin America

Keywords

Central and Eastern Europe, Croatia, historical institutionalism, multipillar pension systems, pension reform

“I call it pension ‘deform’...”
Zoran Anušić

Introduction

Explaining change, especially in path-dependent, ‘sticky’ institutional environments characterised by Pierson’s (2000) increasing returns to power, often poses problems to institutionalists. This difficulty stems from two juxtaposed insights: first, institutional choice as well as its effects are heavily constrained by the same path-dependent elements that the new institutional arrangements try to modify; and second, this choice is contingent on and only possible during critical junctures that interrupt path-dependent processes.

While constrained choice is rightfully borne by the evidence and is central to this study, the bifurcated critical junctures and path-dependency literature attracted much criticism, to the extent that, in a landmark study, Streeck and Thelen (2005: 4-9) convincingly overcame the punctuated equilibrium bias by focusing on change as a combination of process and result.

The authors show how a rigid dichotomy between typically path-dependent incremental adaptation and radical transformation does not capture important transformative processes common to advanced political economies. While, however, their contribution focuses on examples of radical but gradual transformation, this study will analyse processes where institutional rules and practice show a high degree of resilience in spite of abrupt structural reforms, thereby foiling or at least smoothing policymakers’ attempts at institutional breakdown and replacement.

The essay will argue that even if a window of opportunity opens, allowing for structural reforms, the successful conclusion of the legislative phase is no guarantee for discontinuity in institutional rules or practice. In fact, path-departing reform poses additional challenges during implementation, because it presupposes changes in an institution’s formal rules, sanctions, benefit promises as well as in the expectations of the actors involved. In order to account for this possibility, Streeck and Thelen’s framework of institutional change will be adapted and built upon.

The study will propose the concept of ‘institutional degeneration’ to capture a situation where structural transformation takes place, but where, in practice, the old institutional structures ‘contaminate’ the new institutional arrangements, thereby enabling the coexistence of old and new logics of action. This concept complements that of successful institutional breakdown and replacement (Streeck and Thelen, 2005: 9). It will be in fact argued that institutional stability requires institutions undergoing processes of reproduction by adaptation and that these, especially if they are meant to replace an existing institution subject to increasing returns, have to be themselves characterised by positive feedback loops. Therefore, a successful institutional breakdown and replacement occurs when the conditions subsist for new institutional arrangements to enter a stable reproductive cycle. Conversely, degeneration of an institutional design becomes more likely, when these conditions remain unfulfilled. A central objective of this study will hence be to employ as a benchmark some of the

conditions spelled out by Arthur (1994) and redeveloped by Pierson (2000), in order to assess the likelihood of institutional degeneration actually happening.

An interesting case where degeneration has taken place are the sweeping reforms that tried to overturn Central and Eastern European retirement systems' inner logics.¹ To inherited socialist Pay-As-You-Go (PAYG) pension systems, transition to a market economy represented an environment characterised by generalised crisis, which eroded popular support at the base of their reproductive capacity. Betrayal of popular expectations created enough 'negative consensus' – a state of affairs where the status quo is widely regarded as indefensible due to inadequate performance and normative delegitimation, and irrespective of the alternatives – to convince policymakers that an abrupt process of structural change was possible (cf. Brooks, 2006).

The consequent introduction of multipillar pension schemes entailed a dual paradigmatic shift from state to market provision and from collective to individual responsibility. Such structural overhaul was initially perceived as a breakthrough policy fit to avert the old-age crisis, protect the old and promote growth. However, more than half a decade into implementation, the latter is not happening as smoothly as planned.

Using detailed process tracing of Croatian reforms, which represent within this theoretical framework a critical case, it will be convincingly shown that, notwithstanding technically impeccable implementation, degeneration is taking place. Two of Arthur's conditions for institutional reproduction – coordination effects and adaptive expectations – will be employed as a benchmark to evaluate a country's readiness for a paradigmatic shift and it will be argued that in the Croatian case these were not satisfactorily fulfilled. Most significantly, and in addition to instilled structural flaws, the expectations of involved actors (primarily policymakers) failed to adequately adapt to the new norms and, hence, their behaviour does not conform to the new logic of action. Since Croatia was regarded as a great success within CEE, it implies that a blending of new and old logics, which may ultimately lead to the demise of the new institutional arrangement, may be a rather pervasive phenomenon.

Conceptualising Degeneration

In order to meaningfully conceptualise institutional degeneration, a congruent specification of how an institution, its stability and its change are conceived is needed. Streeck and Thelen's framework will be therefore built upon and, contextually, institutional degeneration will be defined as both: a) a process of change, by specifying a range of possible developments that lead to a blending of new with old rules or logics of action; and b) an outcome of change, by determining three ideal types of degeneration using the two variables institutional rules and practice.²

¹ Similar processes are at work in Latin America, thus the concepts described in this essay may be extended to this region as well.

² More precisely, institutional rules refer here to formal rules, sanctions and benefits and institutional practice to actors' adaptive expectations and consequent behaviour.

Institutions as Reproductive Social Regimes

As in Streeck and Thelen’s book (2005: 14), institutions are here treated as social regimes. These are characterised by a ‘triadic’ institutional nature, implying that rule-makers or institutional designers create a set of formalised, obligatory rules that stipulate expected behaviour and rule out undesirable behaviour of rule-takers and which are enforced by a third party.³

Institutional change entails a shift in these rules and relative enforcement procedures so that different behaviour is constrained or encouraged. In the former case, behaviour is a response to the lack of an alternative or to imposition, and in the latter it engenders contingent compliance hinging on perceived gains from trade and observance of the new rules by peers, cf. Levi (1990) and Moe (2005). Change is in both cases caused by the redistribution of the coercive and bargaining resources of power within the institution itself.

Therefore, institutions’ centrality in political contestation, a basic tenet of this theoretical framework, deprives institutional reproduction from its deterministic properties (Thelen, 2004, passim Chapter 1) and hence denies the notion of ‘institutional equilibrium’. In a world where *panta rei*, considering institutions as static reifies reality. More appropriately, stability should be conceived as reproduction by adaptation. In fact, as institutions enter a meaningful self-sustaining state of *reliable* reproduction, contingent compliance of rule-takers diminishes the enforcement costs borne by rule-makers and thus to a certain extent prevents change from occurring.

Focusing now on the innovative features of Streeck and Thelen’s framework, these lay in the conceptualisation of institutional change as a combination of process and result. This distinction yields the following matrix:

Tab. 1 Types of institutional change

		RESULT OF CHANGE	
		Continuity	Discontinuity
PROCESS OF CHANGE	Incremental	REPRODUCTION BY ADAPTATION	GRADUAL TRANSFORMATION
	Abrupt	SURVIVAL AND RETURN	BREAKDOWN AND REPLACEMENT

Source: Streeck and Thelen (2005: 9).

As already mentioned before, the two authors focus on examples of gradual transformation, thereby proposing conceptually distinct processes of institutional change such as layering, drift, displacement etc. In a similar vein, this study analyses an instance of survival and return, namely ‘institutional degeneration’. This is a species of a yet under-researched genus where, despite major shocks or abrupt processes of change, the core institutional structures survive, albeit in an updated form.

³ This definition rules out informal mores and customs, voluntary social conventions, and also organisations where duties are dyadic.

Political-economy literature is ripe with examples of institutional change falling under this category: refoundation through recalibration or functional conversion of old institutions (Thelen, 2004: 34-35), restructuring through decentralisation, reconstitution and recombination (Stiglitz, 1999: 16-18), to name just a few. However, what differentiates these processes from institutional degeneration is that they to a large extent do not entail structural shifts deliberately aimed at classical disruptive change, characteristic of path-departing or otherwise radical reforms.

In fact, institutional degeneration implies that old institutional structures survive *despite* a structural shift taking place. Furthermore, they ‘contaminate’ the new institutional arrangement intended to replace them, thereby creating a hybrid regime, which might, paradoxically, be itself an effective way to overcome the stickiness of the old arrangements.

Therefore, and despite the Croatian being a rather ‘negative’ case, it will be argued that degeneration need not have an aprioristic unfavourable connotation or be necessarily avoided. In certain instances, the resulting institutional hybrid may be a suboptimal, but nonetheless harmless adaptation of the new arrangements to the old logics of action, capable of ensuring the survival of newly legislated institutional formations. Hence, the main defining feature of degeneration is that the originally planned institutional design loses partially or even entirely some of its characteristic properties after being immersed into the pre-existing institutional matrix and implemented by actors responding to old logics of action.

Institutional Degeneration as Process

The success of a newly implemented institutional arrangement, especially in an environment characterised by a sticky, interdependent web of an institutional matrix (cf. North, 1990: 95), is undeniable when the institution enters a self-sustaining reproductive state by producing increasing returns to power. Lacking a competitive market for institutions, the new arrangement survives in parallel or supplants the pre-existent institutional regime.

In order to evaluate whether a given institutional design is more or less likely to generate the dynamic above and successfully replace old institutional rules and practice, the conditions specified by Arthur (1994: 112) and re-elaborated by Pierson (2000) may be effectively used. They entail: large set-up or fixed costs, learning or coordination effects and self-fulfilling (adaptive) expectations. The latter two will be employed in this essay as they directly affect early institutional development.

At this point, an important caveat is due. The original institutional design and, consequently, the subsistence of conditions generating increasing returns are in no way correlated with an institution’s efficiency. Embarking on a path-dependent course may foster inefficiency and increase institutional rigidity. Arthur’s conditions are just a benchmark to assess whether in a ‘struggle for political market share’ the new institutional arrangement will successfully compete with the older regime, whether it will need to adapt to survive or whether it will collapse in dysfunction.

Hence, the main idea is that a period of institutional coexistence may result in an uncertain path of development depending on: a) agency – if actors do adapt their expectations to the new logic of action; b) structure – whether existing or surrounding institutions can create reliable coordination effects. These two courses of action directly emanate from Arthur's conditions. In fact, the more the institutional design is advantageous for the actors involved and the more it is synergic within the existing institutional regime, the higher the probability that during implementation substantial degeneration will not take place.

As for agency, adaptation of expectations may fail to occur with respect to both rule-makers and rule-takers. When institutions are conceived as instruments of power, their mandatory character imposes a certain course of action onto those affected. Most institutional changes, especially those modifying the underlying logic of action, will not be Pareto efficient. They might be efficient (increasing the size of the pie), thereby entailing a potential Pareto improvement, but in reality they will impose losses on some groups and advantage some others. Commonly, losses are concentrated in time and space, while benefits are dispersed. This may trigger a response by both losers (demanding for compensation) and winners (demanding for increased rents) that, depending on the changes in coercive resources of rule-makers, may generate a reversal, capture or modification of reforms.

When institutions are instead figured as cooperative devices, adaptation will be driven by perceived norms of fairness and expected results of institutional change. If rule-takers perceive that free-riding is against their interests, the institution will verisimilarly enter a self-sustaining adaptive cycle. If, on the other hand, their expectations are betrayed, exit will raise the costs of enforceability borne by rule-makers, thereby threatening the new arrangements' existence.

As for structure, it is useful to draw some lessons from varieties of capitalism (cf. Hall and Soskice, 2001) and transition literature (cf. Murrell, 1995; Roland, 2001; Stiglitz, 1999). They both warn against social engineering utopianism as they reject the concept of 'institutional vacuum'. Roland in particular advocates an 'evolutionary institutionalist' approach by which new arrangements are erected on pre-existing institutional structures. Newly designed institutions are in fact never built upon a *tabula rasa* and they should therefore exploit existing institutional complementarities, rather than try to dislocate them. Incompatibility or, worse, an attempt at disruption may as a result lead, even without effective participation of actors or despite their efforts, to path-dependent loops steering off a pre-determined path, possibly – but not necessarily – entering a self-undermining cycle.

Conclusively, the degenerative process can be conceptualised as follows:

Tab. 2 Degeneration conceptualised

	Definition	Mechanism	Elaboration
Degeneration	New institutional rules get contaminated by old norms, new practice by old logics of action	Blending or deformation	<p>Agency Long-term institutional maturity clashes with short-term returns to power for policy-makers, opening space for reversal, capture or modification</p> <p>Adaptive expectations of policy-takers fail to materialise, marginalising the institution or binding it to the same logic of action it was intended to substitute</p> <p>Structure Incompatibility with existing institutional complementarities leads to adaptation to existing structures, decreasing returns or collapse</p>

The possible Outcomes of Degeneration

Institutional degeneration encompasses those examples of institutional change, which combine the disruption of institutional rules with relative continuity in institutional practice. A taxonomy may be therefore created using two parameters: 1) degree of change in the institutional rules at new reproductive state (high, medium, low) and 2) dynamics of change in institutional practice (movements between old, hybrid, new). Three types of survival and return may be thus conceptualised:

Tab. 3 Degeneration three times

Change in institutional rules	Degenerated outcome	Dynamics of change in institutional practice
High	Façade change	Hybrid ← ← ← Old
Medium	Deformation	New → → → Hybrid
Low	Meltdown	New → → → → → Old

Façade change frequently characterises the post-socialist transition. Radically new institutional rules are here compounded with very gradual adaptation of old to new logics of action, more often than not generating hybrids. ‘Il Gattopardo’s’ adage: “*Occorre che cambi tutto, perché non cambi niente*”⁴ well describes this sort of institutional development.

Deformation is a milder version of façade change. Major changes in the institutional rules witness through practice an overturn of one or more logics of action lending support to the new paradigm. The outcome may either be a more or less pronounced adaptation of new to old norms or a marginalisation of the new system, which gets

⁴ “Everything must change so that nothing can change”, own translation.

progressively contaminated by already established practice. This uncertainty is analogous to what happens in layering, where it is not *a priori* known whether the simultaneous operation of core and fringe institutions leads to coexistence or displacement (Streeck and Thelen, 2005: 24).⁵

In the rare cases of meltdown, a comparatively swift reversion of freshly legislated norms restores the system to its original institutional setting. These are instances of non-change, where new policy not only does not leave a lasting mark on institutional practice, but it also does not permanently alter the overarching institutional rules.

Even though multipillar pension systems around the world are experiencing all three forms of degeneration, this essay will focus on deformation, which is characteristic of what is currently happening in Croatia.

Institutional Degeneration in Multipillar Pension Systems

Post-socialist transition economies inherited overblown and inefficient ‘Bismarckian’ pension systems. Whereas each country experienced different problems (Holzmann and Hinz, 2005: 201-203), advanced Central and Eastern European countries enacted (with some exceptions) structural multipillar reforms, which preserved and reinforced income differentiation. These followed the World Bank’s strategy as advocated in ‘Averting the Old-Age Crisis’ (World Bank, 1994: 15).

The Bank’s recipe involved path-departing reforms, which, according to Chłoń-Domińczak and Mora (2003: 132), encompass two different shifts: a) from collective to individual risk bearing, as with the substitution of Defined Benefit (DB) with Defined Contribution (DC) schemes; b) from state to market provision, entailing a partial privatisation of the public pillar.⁶ Conventional knowledge of path-dependent, ‘sticky’ PAYG systems ruled out that such a breakthrough be feasible, and yet private pensions are now common practice.

Within the subgroup of countries that introduced a mandatory funded pillar, implementation of their pension reforms led to radically divergent outcomes. Whereas Croatia is regarded as a success, due to technically impeccable reform execution and positive pension fund returns, Hungary is considered an archetype of failure, due to design flaws and underperformance. Notwithstanding these differences, something is going wrong in most countries. More than half a decade after implementation started, institutional degeneration is affecting their private pillars, leading towards yet unknown directions.

The explanation is rather simple: the ‘new pension orthodoxy’ (Lo Vuolo, 1996: 692) suffers in fact from ‘market bolshevism’, as it inadequately addresses the institutional, political, economic and policymaking characteristics of post-socialist CEE. Thus, the

⁵ Here, however, the mechanism operates in the opposite direction, as it is the new core’s existence to be threatened rather than that of the surviving fringe.

⁶ Voluntary private funded schemes are irrelevant, as they are always potentially present and cannot be considered as a distinctive feature of any reform (Eatwell et al., 2000: 140-141).

new private schemes only partially enter a self-sustaining reproductive process and get contaminated by past institutional practice. The case of Croatia, the most successful one, will show the problem in full.

The New Pension Orthodoxy

This part of the essay will present a sketch of the institutionalist structure and practice of a socialist pension system and confront it with the logic underpinning the new pension orthodoxy. The aim is to provide material to assess the new paradigm's sustainability against Arthur's conditions of institutional reproduction, thereby extending the applicability of the theory beyond Croatia to all countries undergoing structural pension reforms.

The socialist legacy

Socialist PAYG systems, as much as their Western counterparts, reproduced by generating increasing returns to power. However, they developed idiosyncrasies that rendered them vulnerable. Retirement was a *de facto* extension of the constitutionally guaranteed right to work and was therefore Bismarckian in nature, as it was primarily aimed at the industrial labour force. Only later was the socialist pension systems' coverage expanded to other social groups (farmers, self-employed). Notwithstanding relatively flat income distributions, employees were granted earnings-related benefits, calculated according to best- or last-years formulae and financed via employer contributions.

Pensionable age was low by Western standards (55 for women and 60 for men) and benefits rather undifferentiated, however, egalitarian velleities were dispelled by granting privileges to employees who held risky or unhealthy jobs, classified as important for the advancement of socialism. The system was ultimately wasteful and while granting horizontal equity it suffered from vertical efficiency problems (Barr, 1994: 195-196).

Given its formal structure, the socialist pension system generated a conforming adaptation in expectations compounded by:

- shared norms of fairness grounded in solidarity and mutualism, fuelled by socialist propaganda, and very little reciprocity, being the link between input and output severed;
- relatively high expected performance, consisting of above-subsistence benefits and state provision of services irrespective of individual responsibility.

It is evident that such a pension system's reproductive mechanism, including its normative legitimation and expected performance, could be sustained either during periods of high growth or, failing that, through the exploitation of soft budget constraints, a recipe for disaster increasingly savoured in CEE. In fact, after the demise of socialism, retirement was vastly overstretched in the attempt to ease the pressure on labour markets.

Policy-makers increasingly abused it to attain two contrasting objectives: fiscal savings by crushing politically marginal losers and electoral support by disbursing favours to special interest groups. This created widespread disaffection to the system (performance expectations were betrayed and mutualism severed), thereby opening a window of opportunity for paradigmatic reforms.

The new paradigm

At the core of the multipillar structure proposed by the World Bank lies the attempt to correct the distortions to life cycle savings and work decisions generated by poorly designed public pillars, such as those present in CEE. The method to attain this comprises the elimination of privilege and other undeserved redistribution, the tightening of the contribution-benefit link to achieve actuarial fairness, the set-up of mandatory as well as voluntary private funded schemes to diversify risk and promote secondary goals, such as financial market development.

The broad changes in the normative perceptions of the new pension system by rule-takers were thus objectively legitimate and based on:

- fairness deriving from individual responsibility and strict reciprocity between input and output;
- performance expectations proportional to contribution, whereby individual neglect is stigmatised and leads to subsistence-level (or even lower) benefits.

These, combined with a significant shift towards market provision, constituted radical changes aimed at the disruption of the previous system. A breakdown and replacement of a socialist PAYG scheme should have involved, according to Brooks (2006), an open renegotiation of the social contract affecting all social partners and the society at large. However, this hardly happened in any of these countries.

CEE policymakers failed to table a transparent debate on the prospects of reforms and overemphasised the advantages of funding in order to boost the support-generating potential of restructuring. This created vain expectations that the funded pillar may always overperform the PAYG system. Wide political support for reforms was, therefore, based on rather hollow promises, thereby increasing the odds that popular backlashes or policymaker-driven reversals occur.

Why Implementation Fails?

Considering the design of multipillar reforms in CEE, it can be safely argued that neither condition for the generation of increasing returns was fully met at the onset of implementation. Strong coordination effects necessitated more ‘technologically’ advanced financial markets and a successful adaptation of rule-takers’ behaviour required better planned regulatory arrangements or information campaigns. Furthermore, the individualisation of risk implied a decisive renunciation to redistributive policies, and hence the rather implausible repudiation by rule-makers of half-a-century old particularistic practice.

Consequently, degenerative processes driven by both structure and agency started taking place soon after the beginning of implementation. A detailed explanation of the link between these and Arthur's conditions for institutional reproduction follows.

Coordination effects

For the purposes of this essay, two issues stand out: a) the appropriateness of setting up private pension solutions in underdeveloped capital markets; and b) the administrative and institutional capacity to run these schemes.

With respect to the former, Kotlikoff is particularly critical as he argues that betting on the development of financial markets in these countries is like betting on their comparative disadvantage. According to him (Kotlikoff, 1999: 13), the decision to encourage domestic investment in countries with underdeveloped capital markets implies that:

“the Bank finds itself advising [...] to risk large proportions of their workers' retirement incomes on a) the fortunes of a handful of domestic companies whose future success is highly uncertain, b) nominal government bonds that are subject to effective default via government-produced inflation, and c) mortgages and other private loans whose repayment is also subject to great risk. To make matters worse, the return to domestic portfolios in developing countries is highly dependent on the performance of the overall economy – the same economy that determines the wages of pension contributors. Hence, putting workers' pensions in domestic assets ends up greatly compounding the risks they face on their human capital.”

This is manifestly at odds with risk diversification, one of the main objectives of multipillar reforms. Initially, portfolios are undiversified, as the majority of assets is invested in government bonds. Consequently, a privately managed *de facto* replication of the PAYG system is created, which may generate inefficiencies at the expense of taxpayers and the insured, thereby implying that irreversibility of reforms is far from being assured.

The Bank is aware of these ‘theoretical niceties’, however building an efficient financial market represents a desired byproduct of multipillar reforms (Holzmann, 2000: 15). As a benchmark, the Bank developed a set of minimum financial market conditions for successful introduction of funding (Holzmann and Hinz, 2005: 170):

- 1) the presence of a solid core of sound banks and insurance companies;
- 2) a long-term commitment by government to pursue sound macroeconomic policies;
- 3) a long-term commitment to financial sector reform through the establishment of a sound regulatory and supervisory framework for pensions and insurance products and providers.

While condition (1) is linked to structural market features, conditions (2) and (3) constitute within this theoretical framework part of adaptive expectations of policymakers, which are notoriously time inconsistent and fairly likely to be violated.

With respect instead to adequate institutional capacity to handle complex private pension arrangements, there is surprisingly broad consensus that in CEE it was

generally missing. In his work, Barr (2002: 23) enumerates a long list of prerequisites needed for the correct implementation of private pension schemes. In a similar vein, Stiglitz (1999: 12-13) and Dóbrowski, Rostowski, and Gomulka (2001: 4) argue against the sudden instalment of long multi-stage agency chains onto transition economies, since these may simply collapse in dysfunction.

These lacunae have had a negative impact on corporate governance and overall efficiency. Institutional degeneration is structural in that perfect competition is not enforced, and is supplanted by ‘gentlemen agreements’ in the form of oligopolistic structures. It may be argued that oligopolies are simply intrinsic to these countries’ past institutional practice and that they represent a reasonable solution to far worse market failures. However, if these hybrid institutional forms are tolerated by inefficient supervisory regimes and as a result they generate decreasing returns to their clients, then the ultimate demise of the new arrangements shall not be ruled out.

Adaptive expectations

In institutionally dense environments, where one’s action heavily depends on the actions of others, the paradigmatic shift from risk pooling to individual insurance naturally implies radical adaptation of expectations. Changes of behaviour shall be expected from both rule-takers (clients and providers) as well as rule-makers.

Clients are potential losers of reforms, as they are deprived of their rent-seeking positions. Short-sighted employees who relied on redistribution and employers who drifted into evasion shall now abide by the newly established rules. For employers, playing by the rules of the game entails greater compliance, which can be spurred via tax deductions and other advantages of re-entering the formal economy. For employees, instead, it is a matter of financial literacy. The emphasis on individual choice helps overcome long-term myopia, since they have to actively choose a mandatory pension fund as a constituent step in the construction of their old-age insurance.⁷ Of course, the two adaptations are highly correlated, as employers may give in as a result of employees’ pressures.

As it was mentioned in the previous section, funded systems rely on competition in provision as a milestone of reform. The supervisory framework has to create sufficient incentives and sanctions for providers to comply with antitrust rules. In the absence of efficient regulation, smaller and shallower markets are particularly vulnerable to imperfect competition, given the vast array of expedients to circumvent existing safeguards.

Policymakers can substantially gain from multipillar reforms. The main advantages of converting an unfair labour tax into the accumulation of private savings are popular support for structural change and the prospects of bringing to a halt the erosion of compliance and other distorting labour market effects (Holzmann, 2000: 14-15). However, these public goods come at a price.

⁷ The latter change in attitude must not be undervalued. After decades of spoon-feeding, rising awareness of individual responsibility is a major task in all post-socialist countries.

A key difference between PAYG and funded systems is the time elapsing between their set-up and them entering the steady state (cf. Thompson, 1998). While PAYG systems can be rendered operational almost instantly, a fully funded system reaches maturity after operating for 50 years. Moreover, international experience confirms that initial performance of private funds tends to be rather poor and that improvements are linked to: a) greater accumulation, leading to economies of scale and better portfolio allocation; b) fine-tuning of the system, which results from learning processes within regulatory agencies. Therefore, evaluations of the new funded schemes' performance may well precede the appearance of benefits (Brooks, 2006: 20). On top of that, partial internal financing of transition costs means that the protracted diversion of contribution rates to the funded pillar relies on a "convincing commitment that the proposed parametric reform is a lasting one" (Holzmann, 2000: 17).

Considering that time horizons in politics are notoriously short, the mechanisms described above create time inconsistency problems. The reason for that lies not only in the unattractiveness of comprehensive PAYG reforms, but also in the deeply rooted clientelistic nature of partially unconsolidated CEE party systems. Consequently, pension privatisation does not get government out of the pension business and the political risk of policy reversals is not eliminated (Barr, 2002: 19-20).

Failed or partial adaptation of expectations by rule-takers and rule-makers may result in pronounced agency-based institutional degeneration. Clients may call for compensation or modifications and free-ride on the system, providers may exploit regulatory weaknesses and extract rents. While these conducts may be regarded as natural adaptations to unforeseen circumstances, it is their interpretation and transformation into policy that is potentially more harmful. Hence, rule-makers play a disproportionately more important role in the process. Any deviation from the institutional design's logic aimed at raising short-term political capital not only worsens the long-term financial sustainability of the PAYG system, but also directly threatens the existence of the funded pillar. Any tinkering with the public pillar puts in direct competition the new and old systems and necessarily creates discrimination among different pensioner cohorts. Pushing the whole system into a self-undermining cycle becomes then only a matter of political irresponsibility.

Transition and Legislation in Croatia

A short account of Croatian pension reforms will illustrate how the country's retirement system crisis was complete. Normative delegitimation and betrayed expectations generated enough popular support for institutional restructuring, which, under less grim circumstances, would have inevitably clashed with political short-termism.

As a result, the Croatian government embarked during 1998-1999 onto a pension system reform that was meant to be abrupt and discontinuous. Provided that the agenda were carried out as originally planned, the new arrangements would have represented a classical case of institutional disruption, thereby falling into Streeck and Thelen's category of institutional change labelled breakdown and replacement.

The Overdue Death of a Premature Welfare State

Following the collapse of socialism, the transformational recession was in Croatia exacerbated by the war, the loss of the Yugoslav internal market and by a swift drift into a limitedly pluralist 'demo-kratura' under the 10 year rule of President Franjo Tuđman's Croatian Democratic Union (HDZ) (Grubisa, 2002: 38). Output collapsed, inflation soared and unemployment skyrocketed: instead of experiencing a 'J' recovery curve, Croatia ended with a lengthier 'L' curve transformation (cf. Gomulka, 1998). Thus, before fixing the welfare state, stabilisation of the economy was top priority, probably necessitating the shock therapy applied by PM Nikica Valentić in October 1993.

The ensuing price liberalisation (ending the implicit subsidies) and privatisation (establishing hard budget constraints and shifting the responsibility for welfare provision from the firm to the state), the collapse in contribution compliance and hence in state revenues and the increase in absolute poverty, they all rendered social security reforms unavoidable (cf. Wagener, 2002). Similarly to other transition economies, the transformational recession triggered the following string of policy reactions:⁸

- a buffering phase, whereby early retirement and disability pensions were granted to redundant workers in order to relieve overstrained labour markets. These resulted in a sudden collapse of the System Dependency Ratio (SDR)⁹ and increased public pension spending as % of GDP;
- a retrenchment phase, based on poorer indexation to lower than price levels (the abovementioned Valentić package), leading to an exacerbation of conflict due to falling Net Replacement Rates (NRR)¹⁰ and the consequent involvement of the Constitutional Court;
- a concomitant refinancing phase via higher contribution rates, which peaked in 1994.

As a result, the Croatian pension system simultaneously experienced growing expenditures, granted lower replacement rates and witnessed the erosion of its contribution base. The Croatian Institute for Pension Insurance (HZMO) rapidly lost its financial autarky and had to be in part financed via budget transfers.

The pension crisis reached its height in 1999, concomitantly with a harsh recession, which fully exposed the weaknesses of Croatian crony capitalism.

⁸ Within the literature on the political economy of pensions in CEE there are precious few studies analysing Croatia. Anušić, O'Keefe, and Madžarević-Šujster (2003), Müller (2003) and Guardiancich (forthcoming in 2007) are the most comprehensive.

⁹ SDR inverse = Number of insured/Number of pensioners. When the SDR is lower than 3.00, a PAYG system is in bad shape.

¹⁰ NRR = Average net pension/Average net wage. ILO Convention 102 recommends a NRR of at least 40%.

Tab. 4 The Croatian pension system – selected indicators

	Croatia		% change
	1990	2000	
Pensioners	655,788	1,018,504	+ 55.3%
Insured	1,968,737	1,380,510	- 29.9%
SDR	3.00	1.36	
NRR	75.3	42.9	
Spending as % GDP	11.27%	13.26%	
Contribution rate	18.5	21.5	

Source: HZMO (2002).

The end of legitimacy

These developments shattered popular trust in the public pillar. Assuming that Constitutional Court appeals represent a reasonable proxy for pensioners' dissatisfaction, in Croatia these revolved around two issues: 1) severely reduced performance of the system, due to the 'Valentić decrees', which discontinued statutory wage indexation by drastically curtailing HZMO financial resources; 2) the maintenance of privileges granted to vested interest groups, such as veterans, MPs etc.

From the point of view of the insured, the situation was therefore ripe for change. The system became normatively delegitimated and unable to deliver on its promises, as:

- *ad hoc* retrenchment measures significantly added to uncertainty and unjustified discrimination compromised the mutualist nature of normative legitimation;
- expectations of high coverage and 'relatively high' benefits were betrayed. Sliding replacement rates were an univocal indicator of relative decline in the social position of pensioners, and were directly associated with a generalised breakdown of the pension system.

Reform options and choice

Croatia experienced a prolonged debate along the cleavage between reinstatement of existing norms (parametric reforms) and introduction of new ones (paradigmatic reforms). Consensus on a multipillar concept was secured during the now famous Opatija conference in November 1995, after which the World Bank started playing a pivotal role in tilting the balance towards funding.

In order to streamline the pension reform process, a Plenipotentiary comprising internal and external experts was set up at the highest level – the whole PM Zlatko Mateša's restricted cabinet was sitting on the coordinating board. The Bank seconded Zoran Anušić, a former advisor to PM Mateša, and produced one of the key texts underpinning the pension reform's debate, 'Croatia: Beyond Stabilization' (World Bank, 1997). The document offered a range of solutions with an unambiguous preference towards partial funding. Its message was clear:

- the Croatian pension system is costly, inefficient and unable to meet the demographic challenge;
- the funded pillar will outperform the public one. Average long-term replacement rates will amount to 70-80%;
- transition will be chiefly financed internally. Lower indexation, higher retirement age and significant changes to the calculation formula will create major savings in the PAYG pillar.

Popular support and legislation

Once consensus was reached, public support was badly needed to turn all this planning into reality. The opinion polls commissioned by Mateša's government gave credit to soaring popular distrust. In Croatia, more than 70% of those surveyed supported reforms by 1998, even though roughly the same percentage had no knowledge of the reform concept (Anušić, O'Keefe, and Madžarević-Šujster, 2003: 37).

Given the 'negative consensus', structural changes were simply presented as a *fait accompli*. Despite several tripartite consultations taking place, reforms were legislated in an informational vacuum. The six workers union confederations, including the socialist successor Union of Autonomous Trade Unions of Croatia (SSSH), neither had the expertise nor the awareness of the importance of pension reforms (Milidrag-Šmid, interview). Pensioner parties and associations were small, fragmented and incompetent. Moreover, the debate entirely failed to involve younger generations (Mintas Hodak, interview).¹¹ The lack of any alternative comprehensive reform proposal well demonstrates the informational asymmetry and very little civic involvement.

As a result, the multipillar structure was hardly challenged. Discussions revolved around the issues of equalised retirement age and price indexation. In all these cases, giving in was a necessary condition to get the bulk of reforms approved. To sum up, support was garnered by:

- playing on the generational cleavage by overemphasising the virtues of funding to younger generations and underemphasising the transition costs to current and future pensioners. On the one hand, protection of acquired pension rights represented the justification for preventing older cohorts from participating in the mixed system (cf. Brooks and James, 2001). On the other hand, obfuscation of transition costs¹² effectively enabled the shift of the bulk of financing on the 'lucky' excluded;
- granting political compensation for minor demands – retention of privileged occupational schemes, higher indexation and lower pensionable ages.

Eventually, the new multipillar structure was sanctioned by incumbents and opposition alike. In fact, reforms were entirely legislated by the Croatian Democratic Union (HDZ) in 1998-1999, but due to various delays in implementation, they had to be endorsed by

¹¹ Some Croatian experts, namely Zoran Anušić and Predrag Bejaković, assert that the national team's involvement in the 1998 FIFA World Cup is partly to blame for lack of public attention.

¹² The calculation of the Actual Pension Value (APV), a key component of a German point formula, is a chief example.

the initially opposing Social Democratic Party of Croatia (SDP), which was leading a six-party coalition government elected in 2000.

The institutional design

In a nutshell, the newly proposed system entailed an abrupt, dual paradigmatic shift, in that: 1) part of old-age income provision is shifted from the state to private markets by establishing the mandatory funded pillar; 2) risk is largely individualised. In fact, not only the private pillar operates on a defined contribution basis, but also the German point formula is actuarially fair, thereby severely limiting overall redistribution. Tab. 5 presents a brief overview.

Tab. 5 The new pension system

	Croatia
Basic design	Multipillar
First pillar	Public DB German point formula
Contribution rate	14.5% (now 15%)
Second pillar	Mandatory fully-funded private
Contribution rate	minimum 5%
Members	Mandatory: under 40 Voluntary: 40 to 50
Third pillar	Voluntary fully-funded private
Schemes	Occupational or individual

With hindsight, however, the path-departing strategy embraced by the Plenipotentiary contained at least three major flaws. First, it generated unrealistic expectations as high replacement rates referred to a best case scenario. Second, it did not tackle the thorny issue of those 21% of beneficiaries who were granted merit pensions. Third, by relying on internal financing, it inextricably linked the fate of the funded pillar to what happens with the PAYG pillar, thereby rendering private pension schemes vulnerable to populist measures.

As a consequence, the new pension system's institutional design was from the outset incompatible with an environment characterised by underdeveloped financial and capital markets, and by deep politicisation of any issue related to public finance, thereby violating Arthur's conditions for entering a state of reliable reproduction by adaptation. As events unfolded, it became increasingly clear that in its original form, the new system would not supplant the old one and that both structure- and agency-based institutional degeneration was likely to occur.

Implementation and Degeneration

The objective of the last section of the paper is to assess whether the new Croatian pension system entered a self-sustaining reproductive process and to what extent it is deviating from the design's original rules and logics of action.

After briefly describing the implementation phase, which was undeniably and perhaps unexpectedly a success, it will be shown that the new system is experiencing both mechanisms of degeneration, which stem from its inability to reach a self-sustaining reproductive state. Great agency problems in the form of public pillar populism are in fact combined with unforeseen structural inadequacies that represent a potential threat to the funded pillar's sustainability. The result is a hybrid and rather unstable regime, whose future evolution cannot be easily predicted. The last part of this section will therefore try to provide an overall evaluation of the current state of affairs and of future prospects.

The Birth of the Funded Pillar

Proper implementation was in Croatia delayed until the end of 2001 for practical – the economic recession *in primis* – and political reasons – the reappointment sweep by the newly elected SDP-led coalition. Concomitantly, a public awareness campaign was launched as well as competing dissemination of information by newly established pension funds. The state campaign, sponsored by USAID, first focused on education about funded systems and then on registration procedures, ultimately achieving considerable success (Anušić, O'Keefe, and Madžarević-Šujster, 2003: 36). Awareness of reform concepts rose from 32% in July 2001 to 86% in January 2002. More than 88% of those eligible chose their own fund.

It is interesting to compare the results of informational campaigns on choice groups (people between 40 and 50 in Croatia) with other CEE countries, where participation exceeded government projections. In Croatia, only 23% of those eligible opted in. Lower enthusiasm was probably the result of the higher average age of the choice group, less aggressive marketing by pension funds and an on-line program for pension calculation, posted by the Agency for Supervision of Pension Funds and Insurance (Hagena).

From a technical standpoint, the Croatian pension reform is instead regarded as a “*tremendous* success and one of the best reforms [...] to date” (Hurd, 2003: 3). The two independent agencies that accompanied its development, Hagena and the Central Registry of Insured Persons (Regos), played a determinant role in securing the reform's favourable outcome. Regos, a Swedish-inspired central clearinghouse, was established to restructure the whole revenue side of the state budget by creating a unified database of all payroll taxes, surtaxes and contributions. Very impressively, it managed to chart all first and second pillar contributions in a matter of months. By September 2006, Regos correctly assigned 99,42% of contributions to second pillar individual accounts and its efficiency was at least partially responsible for a huge contribution compliance increase, thereby practically annulling transition costs for the 5% second pillar.¹³

Surprisingly and notwithstanding these positive developments, the structural and agency shortcomings of the new pension system's design rapidly emerged. The two will be treated separately hereafter, but it is useful to bear in mind that they are not independent and that combined they may become truly disruptive.

¹³ If compared with the underwhelming performance of the Social Insurance Institute (ZUS) in Poland, these results are simply superlative.

Structural Flaws

The institutional design of the new mandatory private scheme was initially very ambitious. The contribution rate diverted should have amounted to as much as 10% (out of 19.5% total), thereby generating some 35% replacement rate on top of the 30% provided by the remnants of the public pillar.

Of course, the rate contributed to funded schemes depends entirely on fiscal considerations and no amount of regulation can help. This notwithstanding, the successful operation of the funded pillar is instead conditional on strong coordination effects with the surrounding institutional environment. Hence, a shallow capital market, where the stock exchange's first quotation consists of just seven publicly traded companies and where supervisory capacity is low, lacks the prerequisites to painlessly accommodate sophisticated institutional investors, which may soon run out of assets for their portfolios and easily form cartels.

Therefore, overcoming these limits was roughly equivalent to fulfilling Arthur's first condition and would have required specially tailored regulations. Loose investment rules, such as the Prudent Person Principle (PPP), would have broadened the scope of investment, for example to public joint-stock companies or to greater shares of foreign assets. Strong competition requirements (for a discussion see later paragraphs), spurred by Regos and enforced by Hagea, would have avoided excessive concentration among mandatory pension funds and kept administrative costs low.

Most disappointingly, these provisions remained unaccomplished and structural degeneration took place, thereby creating three major institutional problems in the Croatian funded pillar: its inadequate size, the existence of just four funds in a very shallow and initially overregulated financial market and a precarious equilibrium among them, posing the threat of further concentration.

The process tracing of Croatian pension reforms shows that degeneration was instilled already during legislation. The private pillar's size is a primary indicator of its importance. During the legislative process, the Croatian funded pillar was downsized to lower transition costs: a Hungarian stepwise approach should have increased contributions from 5% to 10% by one percentage point per year. Instead, the wording "not lower than 5%" was used, meaning in reality a maximum contribution rate of 5%, the lower end of what is still profitable (cf. Lindeman, Rutkowski, and Sluchynskyy, 2000). A low contribution rate diverted to the funded pillar casts serious doubts on future adequacy of pricey annuities. Moreover, failed equalisation of retirement age by gender means much shorter accumulation for women, which might end up with significantly lower benefits than men.

In addition to limiting the size of the second pillar, the Croatian Minister of Finance (MoF) Borislav Škegro set, for purely fiscal reasons, strict quantitative investment limits, requiring a 50% minimum investment into government bonds. This limitation is now redundant, as domestic fixed-income exposure is consistently higher. At the end of 2005, government bonds represented 72% of total portfolio investment, which violates risk diversification as a major motive for introducing funding. In addition, while returns were consistently above inflation level and outperforming the PAYG system by

registering an annualised reference rate of return (Mirex¹⁴) of 8.03% from the beginning of operations until February 2007, these results will not be sustainable in the future, since they were mainly financed by generous interest on government bonds at the expense of taxpayers.

On top of that, concentration in the funded pillar is very high. Of the initial seven funds, only four survived and the two biggest funds, AZ and Raiffeisen, capture more than 70% of the market.

Tab. 6 Membership and returns in 2005

	AZ	Erste Plavi	PBZ/CO	Raiffeisen	Total
Members 31 Dec 2004	462,291	126,768	194,494	380,091	1,163,644
New members total, of whom allocated by Regos	32,838	9,738	17,175	28,130	87,881
	27,772	7,730	11,836	22,931	70,269
Switching – net change	- 4,458	3,570	920	- 32	-
Membership termination	- 892	- 317	- 573	- 808	2,590
Members 31 Dec 2005	489,779	139,759	212,016	407,381	1,248,935
Membership share	39.2%	11.2%	17.0%	32.6%	100%
Gross RoR	7.69%	8.62%	8.12%	9.19%	8.34%

Source: HANFA (2006: 106-108). * All amounts are expressed in 1,000 HRK.

The table above suggests that there is a latent threat to the system, which may exacerbate conflict between the two bigger and the two smaller funds, possibly leading to further, unacceptable concentration (Vlaić, interview). The risk of drifting from imperfect competition into a duopoly is high and it may be currently happening. The process is the following:

- 50,000 is the minimum pension fund membership requirement and it effectively represent an insuperable barrier to entry;¹⁵
- the clearinghouse, Regos, outsources registration to the box offices owned by the agency for payments, Fina, which, due to Croatian geography (there are more than 1,000 islands), deters many potential switchers;¹⁶
- new members who fail to select a fund are automatically and randomly assigned by Regos to funds according to market share. This crystallises the initial situation and pushes fund managers into apathy, since merit-based competition is emasculated;
- the successful education campaign, which accompanied the establishment of mandatory pension funds, was discontinued after 2002. New participants are poorly informed and hence very few (roughly 1/5) choose a fund, thereby worsening the problem above. One of Barr's preconditions (2002: 23) and a target in itself is a financially literate population and this has been missed;
- the fee structure, changed in 2003,¹⁷ further weakens the incentives for increased competition, as larger funds make fat returns by cashing in the increased

¹⁴ For details, visit <http://www.hanfa.hr/> [cited on 15 April 2007].

¹⁵ The elimination of this requirement is currently under discussion.

¹⁶ Conversely, Latin American excesses are avoided.

¹⁷ It was similar to that of a hedge fund.

management fee. In smaller funds, Return on Equity (ROE) fell to around 10%, a low figure securing survival.

These factors created a rupture in the Croatian pension fund lobby's unity, since the smaller funds develop considerably different interests than the bigger ones. However, a balanced solution is maybe unattainable. Either the situation is left as it stands and the fee structure is improved to provide incentives for profitable management, or (what is being proposed) automatic assignment of members is changed from market share to some other rule, thereby risking to unleash a major marketing campaign, which would almost inevitably lead to the opposite result, that is greater concentration.

Populism and Agency Capture

In addition to coordination effects, the initial institutional design required a major adaptation in expectations of all actors involved, in order to generate increasing returns. The fulfilment of Arthur's second condition depended on three developments: a) greater financial awareness by the insured and a concomitant increase in compliance by their employers; b) healthy competition between insurance providers; c) self-restraint in the demands and consequent intervention by policy-makers. The results were here mixed.

With respect to the conduct of employers and employees, two trends are discernible: increased compliance by employers, probably due to tax advantages, and a concomitant negligence by the insured, which may point to a scarce acceptance of individual responsibility as normative legitimation of the system. The government tried to amend the latter trend by shifting the whole contributory burden onto employees in late 2002, thereby potentially increasing their awareness. As for insurance providers, their behaviour is almost entirely driven by structural considerations. In a small financial market, oligopolistic tendencies may actually guarantee their survival.

What instead undoubtedly drives agency-based institutional degeneration in Croatia are policymakers' deviations from expected institutional practice. Populism in the PAYG system closely followed the Croatian electoral cycle and this suggests that Holzmann's recommendation for a "convincing commitment [...]" has simply not been seriously heeded. In addition, agency capture by competing bureaucratic organisations that feared substantial staff cuts and loss of influence already impeded the ambitious reorganisation of payroll tax and contribution collection assigned to Regos. Political short-termism prevailed over long-term dedication to sound macroeconomic policies and protracted support for multipillar reforms, thereby initiating a worrisome systemic involution, which will probably reach a climax during the electoral bout in late 2007.

A paradigmatic example of how to deviate from newly established norms are the innumerable concessions given first by Croatian PM Ivica Račan (SDP) for the support of pensioner associations in the 2000 elections and later by PM Ivo Sanader (HDZ) to the Croatian Pensioners Party for support in January 2004. Their three seats in the Sabor came to be known as the dearest in Croatian history. The election of HDZ's minority government on 23 December 2003 entailed:

Tab. 7 The HDZ-HSU agreement

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

Source: HSU (3 December 2003).

Probably, not even dedicating the whole parliamentary agenda would have been sufficient to meet all these demands. Although, not many of the promises above made it through parliament, major squandering took place. Wage indexation was quickly withdrawn after IMF protests and a relatively cheap solution for the restitution of the pensioner debt for unlawfully low indexation during the 1990s was found. However, the outcome of all this is relatively simple: the much needed increase in the contribution rate diverted to the mandatory funded pillar will possibly not occur, due to: a) resources already depleted through populist measures; b) first pillar issues that have much higher political salience.¹⁸

The latest populist surge concerns the differential treatment of 'old' and 'new' pensioners. New pensions are calculated according to the German point formula established in 1999 and are significantly lower than those preceding them. The result is that the 'grey lobby' and previously divided and uninterested trade unions united forces in the attempt to correct this downward trend, thereby proposing a whole series of correctives: shorter calculation period, *ad hoc* increases, new computation of the Actual Pension Value and a higher minimum pension – for example equal to 40% of the average wage (SSSH, 2006).

The salience of perceived inequality between the two cohorts gained in prominence as the electoral year 2007 approached and generated an unprecedented hail of promises. In May 2006, the Croatian Peasant Party (HSS) had already sent to parliament an amendment to the 1998 Pension Insurance Act to rectify the situation. Theatrically, PM Sanader's government fully endorsed the issue only months later, and by October 2006 a new working group was established. Social Democrats followed suit in November and presented their own proposal. As Anušić (interview) put it, if such a reform would pass, and it will pass, the chances of increasing contributions to the second pillar will probably disappear.

¹⁸ The Croatian government dedicated one paragraph to future expansion of the funded system in its Strategic development framework 2006-2013 (Vlada RH, 2006: 48).

Putting in Place a Reproductive Process

The developments in the Croatian pension system illustrate that the shock provoked by the abrupt process of change has not been reabsorbed yet. It cannot be safely stated that private pension funds already settled into an increasing returns path leading to a relatively stable reproductive state. A proper blending of old and new practice occurred in a number of areas, which implies that a degenerative process, which I termed deformation, has taken place. In the Croatian case, this is definitely a negative outcome.

For the system to survive in at least the current, hybrid form, not letting the mandatory pillar drift into marginalisation or develop a duopoly is key. As a result, several regulatory modifications are being considered and have been enacted. These range from a cap on administrative fees to a different formula for the automatic allocation of undecided new employees. Notwithstanding, two main obstacles, which are not restricted to Croatian pension insurance, stand in the way.

First, any regulation that interferes with the operation of mandatory pension funds will be filtered by the insured to begin with. Thus, its effectiveness will significantly depend on their adaptation of behaviour, which in the absence of adequate financial literacy may again lead to unexpected results. Consequently, a fundamental decision has to be taken, whether to restrict the rule-takers' freedom of choice to protect them from their own mistakes, or not.

Second, until the funded pillar enters a stable reproductive cycle with positive feedback loops reverberating throughout the economy, political short-termism poses a constant systemic threat. There is a number of internal – setting up a Notional Defined Contribution public pillar – and external hands-tying arrangements – borrowing credibility by complying with the Maastricht criteria or various stand-by agreements stipulated with International Financial Institutions (IFIs) – that radically restrict the political room for manoeuvre, thereby to a large extent preventing populist behaviour. However, before putting in place these commitment devices, a hard question needs to be answered: is it appropriate to deprive politicians of decision-making power in case a crisis with serious social consequences breaks out?

Institutional degeneration of multipillar pension system is a relatively new and under-researched phenomenon. Hence, international practice is still insufficiently consolidated to provide satisfactory answers to the dilemmas above. Even so, failing multipillar systems already spurred a major debate and some rethinking by the same IFIs that orchestrated the whole experiment. The World Bank, in fact, acknowledged the need for ample time spans to set up an adequate administrative and institutional superstructure (Holzmann and Hinz, 2005: 152), while USAID went a step further by arguing that a simple, single-pillar (funded or PAYG) structure is probably better (USAID, 2005: 53-54).

Conclusions

The essay employed contemporary institutionalist literature to analyse the pension system reforms that were implemented in Croatia after 1999. To this end, it developed a conceptual analysis to understand the institutional processes in countries where structural change has taken place, thereby breaking the path-dependent constraints typical of mature PAYG pension systems. The analysis advanced the concept of ‘institutional degeneration’, which is characteristic of those situations where structural transformations take place, but where old institutional arrangements survive and blend together with the new institutional structures. The aim of the concept is to expound that there are intermediate transformative processes between typically path-dependent incremental change and radical transformation, whereby institutional structures may seem to change drastically in the surface, but in practice reproduce inherited institutional logics.

The main concepts were developed by building upon Streeck and Thelen’s theory of institutional change, which convincingly departs from the classical dichotomy incremental versus radical transformation. As such, their framework comfortably accommodates institutional degeneration, by allowing for those instances where despite the successful conclusion of the legislative phase, there is no guarantee that discontinuity in institutional practice will take place.

In order to assess whether an institutional design will successfully replace an existing regime or whether it will undergo degenerative processes, two of Arthur’s conditions for the production of increasing returns to power were employed, namely adaptive expectations and coordination effects. In a nutshell, the more the institutional design is advantageous for the actors involved and the more it is synergic within the existing institutional regime, the higher the probability that during implementation substantial degeneration will not occur. Failing that, an adaptation of the new institutional arrangements to old logics of actions will be verisimilarly necessary to smooth out the transition from one regime to the other.

Consequently, two different dynamics of degeneration were described: the first related to agency and hence depending on the adaptation of actors’ expectations to the new logics of action, and the second to structure, depending on the capacity by existing institutions in combination with the new ones to create reliable coordination effects.

The paper empirically substantiated the overarching concepts by analysing the replacement of socialist PAYG systems with multipillar schemes, which entails a dual paradigmatic shift from state to market provision and from collective to individual responsibility. It was argued that due to the original design’s problems, the implementation of multipillar schemes is not happening as smoothly as it was planned. In this respect, Myles and Pierson (2001: 330) were rightfully unforgiving: “...attempts to design an optimal system and then insist governments adopt it, as the World Bank has done, is unhelpful at best and a distracting form of utopianism at worst.”

The same applies for the Croatian case, where it was shown that Arthur's conditions were not satisfactorily fulfilled. Most significantly, and in addition to instilled structural flaws, the expectations of involved actors (primarily policymakers) failed to adequately adapt to the new norms and, hence, their behaviour deviates from the new logics of action. Since Croatia was regarded as a great success within CEE, due to its almost impeccable pension reform implementation, it implies that a blending of new and old logics may be a rather pervasive phenomenon, which deserves very careful planning to be avoided.

Ultimately, it is still uncertain whether funded pensions undergoing degenerative processes will drift into marginality or survive in a more or less hybrid form. Additional research on those intervening factors (hands tying arrangements, commitment devices) that limit the variability of institutional reproduction may lead to stimulating new understanding of a whole series of processes of change, whose ultimate outcome are hybrid institutional rules and practice.

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