

# Pension Reform in Europe

Politics, policies and outcomes

*Edited by*

**Camila Arza and Martin Kohli**

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and *Administration* 40, 5 (2006), and 'Pension reforms in Europe and life-course politics' (with R. Maier and W. De Graaf), *Social Policy and Administration* (forthcoming).

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# Preface

Over the past decades, pension systems have come to the fore of policy-oriented academic research. The strains on public finances produced by population ageing coupled with an eroding tax base have boosted a debate that has increasingly moved to the fundamental issues of the roles of the state and the market in welfare provision, and of public and private responsibilities. Pensions have long been a key element in national welfare systems, but their implications for these basic welfare issues have made them acquire much wider significance. The overwhelming interest in academic and policy circles on the future of pension policy has also resulted from the characteristics of pension systems themselves. Pension policies have consequences much beyond simply providing income security in retirement. They touch upon questions such as the scope for public action, its effects on economic growth and social wellbeing, and its distributional outcomes in terms of ‘who gains’ and ‘who loses’ from public policy. They are, moreover, one of the central arena where corporatist games between the state, business and labour organisations are being played. And unlike other group-specific or targeted policies, they have (or will have) direct implications for the entire population – as contributors earlier and as beneficiaries later.

This book has been conceived to provide answers to some of the fundamental questions that have arisen from recent pension reform attempts: how do welfare institutions change and what is the role of bargaining games and negotiated trade-offs in initiating and implementing these changes? Who are the actors involved and how do they interact? What are the ‘new ideas’ on old-age security and how have they affected policy design and outcomes? What are the distributional consequences of pension reform? What have been the successes or failures of alternative reform designs? Do recent reform processes reflect the existence of an intergenerational conflict or a fading support for the welfare state? Our conviction that these questions require an interdisciplinary and comparative answer has stimulated our search for interaction between scholars from different backgrounds. The interdisciplinary and comparative approach also allows us to fill a gap in the research literature, which has been mostly oriented to describing institutional design changes in individual countries. Our goal is more ambitious: to discern what is behind and what is ahead of these institutional

changes: in other words, how reforms were produced in the policy process and what their likely outcomes will be.

This productive exchange was initiated in the Workshop on Pension Reform in Europe, held at the European University Institute (Fiesole/Florence) on 13–14 May 2005, and jointly organised by Camila Arza, Martin Kohli and Martin Rhodes. The format of the workshop asked for comparative presentations, to be centred not on single country cases but on systematic issues of politics and policies. We aimed to bring together some of the most important academic experts working on the origins, trends and outcomes of recent pension reform in Europe, and almost all of them followed our call. In the light of the discussions at the workshop, they have in the meantime thoroughly revised their chapters, and made them speak more to each other.

Many people have contributed to make this book possible. We are indebted to the Robert Schuman Centre for Advanced Studies and the Social and Political Sciences Department of the European University Institute for generous financial support for the organisation of our first meeting. We are especially grateful to Martin Rhodes, who has first been an active co-organisier and participant of the workshop, and then has provided accurate and intelligent advice for the preparation of the structure and content of the book. Our thanks go also to Helen Wallace (until recently the Director of the Robert Schuman Center) for her support, and to the students and researchers who have participated in our discussions, thus helping all the contributors to develop and sharpen their arguments. We trust that this book will also help them and all others who endeavour to understand the social and political origins and implications of welfare reform in Europe.

C.A. and M.K.

# Abbreviations

ABO	Accrued Benefit Obligation
AOW	<i>Algemene Ouderdomswet</i> (General Old Age Pensions Act)
AP	<i>Allmänna pensionsfonder</i> (National Pension Funds)
ATP	<i>Allmän Tilläggs-pensions-system</i> (Supplementary Pension System)
BSP	Basic State Pension
CEE	Central and Eastern Europe
CFDT	<i>Confédération Française Démocratique des Travailleurs</i> (French Democratic Confederation of Work)
CFO	Chief Financial Officer
CGT	<i>Confédération Générale du Travail</i> (General Confederation of Work)
DB	defined-benefit
DC	defined-contribution
EMU	European Monetary Union
ERISA	Employee Retirement Income Security Act
EU	European Union
FASB	Federal Accounting Standards Board
FDC	Funded Defined-Contribution
FO	<i>Force Ouvrière</i> (Worker's Force)
FSU	Former Soviet Union
FSV	<i>Fonds de Solidarité Vieillesse</i> (Old-Age Solidarity Fund)
FTSE	Financial Times Stock Exchange
GDP	Gross Domestic Product
GP	<i>Garantipension</i> (Guaranteed Pension)
IFI	International Financial Institution
IMF	International Monetary Fund
IP	<i>Inkomstpension</i> (Income Pension)
IRA	Individual Retirement Accounts
ISEA	International Survey of Economic Attitudes
ISJP	International Social Justice Project
ISSP	International Social Survey Program
MIG	Minimum Income Guarantee
MP	Member of Parliament
NDC	Notional Defined-Contribution

NPSS	National Pension Savings Scheme
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
ÖVP	<i>Österreichische Volkspartei</i> (Austrian People's Party)
PAYG	pay-as-you-go
PBGC	Pension Benefit Guaranty Corporation
PBO	Projected Benefit Obligation
PC	Pension Credit
PP	<i>premiepension</i> (Premium Pension)
PPF	Pension Protection Fund
RC	<i>Rifondazione Comunista</i> (Communist Reconstruction Party)
S2P	State Second Pension
SAP	<i>Socialdemokratiska Arbetarepartiet</i> (Social Democratic Party)
SEC	Securities and Exchange Commission
SERPS	State Earnings Related Pension Scheme
SP	<i>Særlig Pensionsopsparing</i> (Special Pension Saving) (Denmark)
SP	Stakeholder Pension (UK)
SPD	<i>Sozialdemokratische Partei Deutschlands</i> (Social Democratic Party of Germany)
SPÖ	<i>Sozialdemokratische Partei Österreichs</i> (Social Democratic Party of Austria)
TFR	<i>Trattamento di fine rapporto</i> (End of contract benefit) (Italy)
UK	United Kingdom
UN	United Nations
US	United States
USAID	United States Agency for International Development

# 1 Introduction

## The political economy of pension reform

*Camila Arza and Martin Kohli*

### The issues

In current accounts of pension policy, and of the welfare state more generally, there is something of an implicit consensus that emphasises path dependence and obstacles to reform. This book takes issue with such accounts. By focusing on the most recent reform experiences, it observes a trend towards some convergence between different paths and towards substantive change. It offers several approaches to explain this process.

The idea of a limited number of welfare regimes in terms of specific patterns of institutions, and of path dependence in terms of change processes that would deepen rather than flatten this specificity, has been a powerful corrective to the earlier assumption that the dynamics of capitalist modernisation would eventually make all countries converge on a single institutional model. But the new consensus has in its turn decreased our capacity to observe and make sense of what is going on today, by unduly limiting our attention for changes that do not fit the assumed paths, and our tools and concepts for giving them form.

The decades since the end of the Second World War have throughout been a period of major transformation in pension policy. Pension reform has become central to the European social policy agenda – first in terms of construction and expansion, then increasingly in terms of consolidation and retrenchment. The high levels of pension expenditures experienced in the past few years, and projected for the coming decades, have become a key concern for fiscal and labour market policy and economic growth.

Pension systems thus need to be viewed in a broader political economy framework. Their major purpose is to provide income security to retirees. In addition to such redistribution across the life course, they may also aim at redistribution across population groups, such as lifting the low-income elderly out of poverty. But beyond these goals, they are linked up with a range of other issues.

- They are typically the largest public transfer programmes, and thus the source of major fiscal pressures (and sometimes opportunities).
- They influence financial markets by creating or impeding the accumulation of funds and the rate of personal savings.

- They regulate labour markets by facilitating an ordered transition out of employment.
- They enable employers to manage their workforce by offering instruments for the shedding or replacement of workers.
- They contribute to the institutionalisation of the life course by creating a predictable sequence and timing between work and retirement.
- They provide workers with a legitimate claim to compensation for their 'lifelong' work, and thus with a stake in the moral economy of work societies.
- They produce new social and political cleavages by creating large groups of actual and potential beneficiaries.
- They structure the agenda of corporatist conflict and negotiation.
- They offer opportunities for administrative offices and jobs.
- They weigh in on election outcomes.

Through all these issues, they form a major part of the political economy of current societies.

In this introduction, we take up the issues first through an examination of the historical evolution of pension systems (and by that, of retirement as a universal new life stage), and second, through a discussion of the research literature. In the third section, we present an overview of the book's contributions, and finally come back to its overall results.

## **The evolution of pension systems**

The origins of modern public pension policy can be traced back to the last few decades of the nineteenth century, when the first two pension schemes (which would become the two key models for pension policy-making) were set up: the (work-based earnings-related) German scheme in 1889, and the (universal flat-rate) Danish scheme in 1891. Following these examples, either universal or work-based pension systems were created over the first half of the twentieth century in all European countries. The early schemes followed different models or regime types, but they all tended to provide low benefits at rather high retirement ages. The idea of 'retirement' was just starting to be constructed and pensions were often conceived more as disability allowances than as retirement benefits as such (cf. Kohli 1987). Retirement age was around 70 years in most countries, and life expectancies were low, thus making the period of benefit receipt rather short. As a result, expenditures in pensions remained modest relative to current levels.

The big expansion of pension systems came after the Second World War. In countries where pensions were restricted to some specific occupational sectors, coverage was broadened to the entire working population. Countries with only basic income protection (flat-rate or means-tested benefits) also expanded coverage, sometimes eliminating the means-testing, sometimes including new earnings-related layers in the public scheme, or mandating occupational schemes.

Eligibility became more generous, normal retirement ages were reduced, and early retirement options were introduced in many countries (cf. Arza and Johnson 2005). In some cases, easier-to-meet eligibility rules were only applied to some occupational categories, reflecting the hazardous nature of some occupations, but also political power and influence. By and large, with the expansion of coverage and benefit generosity, pensions became a comprehensive system of income protection in old age. Their role for public policy broadened as they increasingly became a key instrument for industrial restructuring and for managing unemployment (Kohli *et al.* 1991).

Retirement as a universal new life stage thus became fully institutionalised in the second half of the twentieth century only. It was fuelled by the economic boom of the 1950s and 1960s when many countries started to provide pensions at a level of wage substitution – either through public pay-as-you-go systems or through broad occupational pensions – which allowed for a full exit from the labour force at a specific (and increasingly early) age. The long-term evolution of retirement has been striking, as can be demonstrated for Germany, which in 1889 introduced the first public pension system available for large parts of the population. Between 1881–1890 and 2002–2004, the proportion of men surviving to age 60 has increased from 33.5 to 87.8 per cent, and the average life expectancy at age 60 from 12.4 to 20.1 years. These added years are now increasingly spent in retirement: the labour force participation rate of men aged 60 or more has dropped from 67.9 per cent in 1895 to 14.4 per cent in 2004. In other words, retirement has become a life stage of its own, to be expected by the majority of the population, of considerable length and structurally set apart from gainful work (see Kohli 2000).

The long periods involved in the maturation of the new pension rules introduced after the Second World War meant that in many countries their full financial impact would not be observed immediately, but only some decades later, when the generations under these schemes started to retire. More importantly, the age structure was still that of a young and growing population, with a broad base of young and a narrow top of older ages. As a result, pension expenditures in the 1960s and 1970s were still rather low. In 1960, they amounted to 3.6 per cent of GDP in Sweden, 3.3 in Italy, 3.7 in the Netherlands, 2.6 in France, 5.9 in the Federal Republic of Germany, 1.2 in Spain and 3.1 in the UK. In 1980, they had more than doubled in most countries, reaching 9.6 per cent of GDP in Sweden, 6.9 in Italy, 11.4 in the Netherlands, 7.6 in France, 9.6 in the Federal Republic of Germany, 5.7 in Spain and 5.5 in the UK. Pension expenditures generally continued to rise over the 1980s to reach, by 1989, over 9 per cent of GDP in France, Germany and Greece, and over 11 per cent in Sweden, Italy and the Netherlands.<sup>1</sup> Further expenditure growth projected for the new century started to be seen as a risk for the sustainability of public finances and the competitiveness of national economies.

Over the 1950s, 1960s and early 1970s, in an environment of sustained economic growth, the impact of pensions on public finances was less of an issue than it is today. Governments allocated a significant part of their budgets to

welfare expansion, in a context where public expenditure and aggregate demand were seen as key ingredients in the economic growth strategy. But things started to change after the mid-1970s. Growth rates fell, population ageing became more pronounced, and pension systems matured. Economic ideas started to shift away from Keynesianism, towards new supply-side policies which stressed productivity, international competitiveness and stringent public finances. The high wage contributions required to finance the growing level of pension expenditures (especially with pay-as-you-go financing) did not fit these ideas. The rising level of future pension commitments was also seen as a risk. Political attention thus started to shift to pension reform: in economic as well as in political terms the key puzzle was how to make existing pension schemes financially sustainable for the future while maintaining their effectiveness.

The rhetorics of 'reform' have also been important. Most of the policy steps that currently go under this label consist of 'retrenchment', in other words, of cuts in existing welfare state programmes. More neutral terms for what is going on would be 'change' or 'transformation'. The choice of terms is clearly not innocuous. As Vivian A. Schmidt has observed, 'no major and initially unpopular welfare-state reform could succeed in the medium term if it did not also succeed in changing the underlying definition of moral appropriateness' (Schmidt 2000: 231), and changing this definition requires convincing rhetoric and discourse. We speak of 'reform' here because it has become the general terminological currency. It also has some basic arguments going for it, in the sense that the existing pension schemes face increasingly stringent financial challenges, partly through the combined demography of low fertility and increasing life expectancy, and partly through the stronger exposure of national economies to global competition. But the translation of fiscal pressures into specific institutional changes owes much to the new mainstream of economic thinking and lobbying about the need for welfare state retrenchment and the merits of privatisation.<sup>2</sup> This should be kept in mind when speaking of 'reform'.

Solving the financial puzzle was certainly not easy in the new demographic context. The proportion of the total population over 65 years of age, which in 1950 was at only 9.1 per cent for the EU15 average, reached 14.3 per cent in 1990, and is projected to grow up to 20 per cent in 2020 and 27.6 per cent in 2050.<sup>3</sup> As to expenditure projections, estimations in the 1980s were that, in a no-change scenario, pension expenditures would soar to 20.8 per cent of GDP for the EU15 average in 2050.<sup>4</sup> Although some doubts have lately emerged on how precise these estimations were, it is agreed that a major growth of pension expenditures was to be expected. In any case, these projections granted pension reform a privileged place on the policy agenda. Governments throughout Europe started to discuss reforms which could go from small parametric adjustments all the way to major structural change.

Since the late 1980s, many reform plans have been approved and implemented. About 25 pension reforms affecting either specific groups of the population or the entire pension system were passed in EU countries over the period 1986–1990.<sup>5</sup> In the following five-year period (1991–1995), this number



increased to 36, and in the past few years (from 1996 to 2002), to 55.<sup>6</sup> Although the number of reforms is not a comprehensive indicator of the magnitude of the changes taking place, it gives some illustrative idea of the importance of the pension issue on the policy agenda. The direction of reform has been, more often than not, towards a reduction of future expenditures, and increasingly so as time went on. While just over half the reforms introduced in the 1986–1990 period tended to reduce the generosity of the system, over three-quarters of the reforms passed between 1991 and 1995 moved in that direction. This was the period of ‘cost-containment’ during which indexation rules were modified, access to early retirement schemes was restricted, retirement ages were raised and a number of other specific parametric adjustments were introduced with the aim to restrict eligibility and reduce future benefit levels. In the most recent period (1996–2002) reforms have continued in this direction although in many cases they have also introduced a new feature: the creation of compulsory or voluntary private individual pension accounts (encouraged through tax incentives), with the aim to at least partly compensate for the projected fall in public benefits.

Beyond bare retrenchment, one of the key strategies of reform throughout Europe has been to operate via incentives: incentives to work, incentives to save, incentives to retire later. Labour market activation has become a key feature of European social policy. Early exit from the labour force, long encouraged by consensual strategies of all labour market actors, has come to be considered one of the central problems facing pension finances. While raising the retirement age limit beyond the traditional threshold of 65 remains highly contentious, raising the labour force participation below this threshold is now a broadly consensual goal, as stated, for example, in the Lisbon and Stockholm agenda of the EU which asks member states to reach a labour force participation rate of at least 50 per cent among the population aged 55–64 by the year 2010. Institutional incentives embedded in new eligibility rules and pension formulas are aimed at pushing the retirement decision up to later years. The critical issue that has generated conflict here is to what extent this is indeed a free decision by the worker, and to what extent it is enforced by, for instance, health reasons or labour market conditions. Defined-contribution arrangements, in which the level of benefits depends on contributions made, are often advertised partly because of their expected impact on labour market participation, even though the same goals could be reached through defined-benefit arrangements with actuarially fair discounts for early retirement. The decision to introduce tax incentives for private pension schemes (e.g. in Germany, UK, Italy) has also been a political one. Incentives can be appealing for all because, in principle, there is no forced change in behaviour: those who just wish to ignore them can do so. In practice, the introduction of incentives has often been combined with some forced change, for instance, when rejecting the ‘incentive’ to work longer under defined-contribution formulas means receiving a lower benefit. Moreover, as tax incentives have a public budget cost which is paid by the whole population, individuals in their role as tax payers cannot really opt out of them: they continue to pay for the incentives taken by others.

These reforms have entailed a new role for the market in the provision of pensions. Privately administered funded pensions, investing workers' contributions in the financial market, were not a European invention. Already in the 1980s, Chile had established the first large-scale private system of individual pension accounts. In 1994, the influential World Bank report *Averting the old age crisis* advocated the development of these schemes as one of the pillars in the 'three-pillar model' that has been largely applied in Latin America first, and Central and Eastern Europe later on (World Bank 1994). Although the World Bank prescriptions did not have a direct impact on Western European policy-making, the idea of pension funding and savings has gained greater attention by policy-makers as a new instrument to deal with the sustainability of public pension finances. In a step by step process, European countries have started to introduce voluntary or compulsory funded schemes, which are in most cases privately administered (the exemption being Sweden) but with various degrees of public regulation – an issue of sustained contention. This has occurred as much in countries with a long history of private provision (like the UK), as in those where a public single-pillar pay-as-you-go system was dominant (like in Italy and Germany). The idea of funding has not been restricted to private sector pensions. Some countries have introduced (or developed existing) 'buffer funds', i.e. a system of asset accumulation for public pensions aimed at guaranteeing financial sustainability over the demographic transition. As a result, total pension assets have been projected to increase markedly in many countries over the period from 2004–2050: from 135 to 243 per cent of GDP in the Netherlands, from 39 to 61 per cent in Sweden, and from 52 to 73 per cent in Finland.<sup>7</sup> Similar rises of pension assets have been projected for the Central and Eastern European countries where the shift to funded pensions was compulsory.

### **The research literature**

Just as pension systems and pension reform have been central to policy agendas, they have been central to the welfare literature. Since Esping-Andersen's seminal *Three worlds of welfare capitalism* (Esping-Andersen 1990), the welfare regime concept has influenced most welfare research. 'Regime theory' has been oriented to evaluate how the diversity of institutional designs across countries was affected by different political orientations (and hence, ideas and power resources of different groups), and has produced different welfare outcomes – thus creating clusters of countries with similar institutional design, similar political orientations and similar outcomes. A substantial part of the research that followed was aimed either at empirically evaluating these welfare clusters (e.g. Goodin *et al.* 1999), at generating new clusters and typologies (Castles and Mitchell 1993; Ferrera 1996, 1998), or at revising the overall methodological approach (Kasza 2002). For pension systems themselves, recent reforms have put both 'regime theory' and the earlier Bismarckian-Beveridgean classifications under greater scrutiny, and new analyses have emerged to address the most recent reform pathways and the new 'pension regimes' (Myles and Quadagno 1996; Bonoli 2003; Natali 2004b, 2005; Ebbing-

haus 2006; and Arza 2006). The reforms have changed what originally was defined as models and ‘regimes’. As countries with different systems have adopted similar design features, the original classifications are no longer appropriate for comparison. Chapters 6 and 7 in this book are concerned with pension models and their outcomes. But rather than aiming at an overall classification of countries in clusters, they examine the specificities of system design, and use the results to comparatively evaluate reform pathways and impacts. This takes account of the increasing complexity of pension systems (and of the combination of ‘layers’ and ‘pillars’ within each system), and gives a new dynamic to the analysis (often too frozen in regime classifications).

The concept of policy models or regimes has also been connected to the literature of institutional change, widely developed in the past decade. Implicitly, ‘regime theory’ underpins a static conception of welfare (see Streeck and Thelen 2005 for a critical account). If clusters are determined historically as a result of the original political orientations and institutional choices of countries, it is unlikely that they could be rapidly modified, because they are not only sustained by the country-specific welfare principles, political ideas and national identities but have created their own conditions for continuity in the form of cleavages and constituencies. The idea of institutionally constrained and path-dependent welfare reform was put forward by Paul Pierson in his original study of pension reform in Britain and the US (Pierson 1994), and pursued further in the years that followed (Pierson 2000a, 2000b, 2000c, 2004). The key argument is that long-lived welfare structures are very difficult to modify because of the social expectations they generate. In the pension policy arena, this refers to the expectations of people, but also of specific groups which may have a strong commitment to certain policies (such as trade unions in ‘Bismarckian’ countries). Countries thus become ‘locked in’ in their once-established institutional arrangements, and change can be only incremental. The path-dependence literature responded to the empirical evaluation of welfare reform attempts, especially over the 1980s and early 1990s, when the argument was convincing because the empirical evidence for it was strong. But over the late 1990s and into the new century, many countries, including some Western European ones, managed to implement broader and sometimes structural reform processes. With this new wave of structural reform, the idea of path-dependence has come under scrutiny, and questions have arisen as to the conditions for overriding existing institutional (and hence political) constraints.

The idea of institutionally constrained change and of the conditions under which reform is possible has brought in a great deal of work on the political economy of pensions, that is, the negotiated influences and games underpinning pension reform ‘success’ (e.g. Natali 2004a on the role of trade unions, Schludi 2005 on the political and corporatist bargains, and Brooks 2005 on the role of local and international factors in pension privatisation). This political economy approach is at the basis of the four chapters that make up the first part of this book. Natali and Rhodes (Chapter 2) show how reform is not just an act of blame-avoidance, but often as well an act of credit-claiming whereby governments try to get support from improving the deficits of the system. In ‘successful’

reforms, there is often a negotiated process which brings in social partners and opposition parties. Both Natali and Rhodes (Chapter 2) and Schludi (Chapter 3) deal with the specificities of these bargaining games and political exchanges, which are indeed the conditions under which reforms can be made feasible in a context of strong institutional constraints. Overbye (Chapter 4) directly challenges the idea of path dependence, and argues that the political psychology of pension reform is important – framing and packaging reforms so that they are perceived as pursuing valuable goals may be more important than institutional degrees of freedom in explaining which reform attempts are successful and which are not. Müller (Chapter 5) studies the political economy of structural reform in Central and Eastern European countries – the major path-breaking European reformers so far – and highlights the role played by the newly dominant epistemic community: the ‘new pension orthodoxy’.

Radical reform has meant, in most countries, a greater role for the private sector, and in some of them (especially in Central and Eastern Europe), a shift from unfunded (pay-as-you-go) to funded schemes. Structural change implies that the entire institutional design is being modified, but its impacts on specific outcomes are less clear. How design and outcomes are connected has probably been the most widely debated issue in academic and policy-making circles in the past decades, starting with the first advocates of pension funding and privatisation (e.g. Feldstein 1995, 1996, 1997; Feldstein and Liebman 2000, 2001; James 1996, 1997) who framed much of the debate that followed. Another set of studies has been more critical on the merits of these proposals, highlighting the ‘myths’ and ‘truths’ of pension funding and privatisation (e.g. Orszag and Stiglitz 2001; Barr 2002; Eatwell 2004; Cesaratto 2005). The recent reform processes have generated new concerns as to the distribution of risks (e.g. Schmähl 2003). Historical analyses have critically evaluated the origins and development of private pension provisions by focusing on their connections with the financial sector and on the emergence of new powerful actors in this field (Blackburn 2002 and Chapter 8 in this book). The debate has expanded with the development of new pension models going beyond the funded vs. pay-as-you-go dichotomy (such as notional defined-contribution schemes, see Cichon 1999; Disney 1999 and Holzmann and Palmer 2006), and the integration of reform experiences into a more ‘balanced’ World Bank approach (e.g. Holzmann and Hinz 2005; Gill *et al.* 2003). The aim has always been to answer the key policy question of which system design better serves a set of policy objectives, but while the most important objectives over the 1990s were financial sustainability, aggregate savings and private provision, poverty prevention and benefit adequacy have slowly gained greater attention. The chapters in this book show that the analysis of outcomes needs to go beyond the comparison of one broadly defined model over the other (pay-as-you-go vs. funding, private vs. public, flat vs. earnings-related), to better understand the effect of each layer of a complex system on the outcomes for different groups of the population in a particular context. Thus, Frericks and Maier (Chapter 9) evaluate the gender impact of the specific elements of welfare regimes and their interaction with the particular

position of women in the labour market; and Arza (Chapter 6) shows the distributional principles, and likely distributional effects, of the new combinations of layers and pillars in current pension systems. This calls for a shift of attention, from the big comparisons between regimes and models, to detailed empirical assessments of the effects of each single element of a model, of its operation in the overall system, and in the social, economic and demographic context of each country.

As change has accelerated in welfare provision, the role of welfare ideas and attitudes towards the welfare state has also become a key issue for political and sociological welfare research. Interest for it has been motivated by the implications that ideas and attitudes can have for both the politics of pension reform (what principles, models, and institutional designs do individuals prefer and support? How important is this support for the successful implementation of reforms?), as well as for 'regime theory' (do attitudes cluster along the same lines as institutional systems? Have clusters of attitudes changed?). Recent work has assessed the change in welfare principles and ideas in the context of major reforms (e.g. Cox 1998; Plant 2003; Taylor-Gooby 2005). The extent to which attitudes differ across welfare regimes is relevant for understanding the social basis of welfare clusters, and thus the logic of welfare regimes as socially entrenched modes of welfare production. The increasing availability of population survey data has made it easier to answer some of the longstanding questions on whether attitudes towards welfare and welfare reform differ across countries, over time and/or between generations (see, for example Svallfors 1997; Svallfors and Taylor-Gooby 1999; Boeri *et al.* 2002; Gelissen 2000). The discourse of 'generational equity' has gained ground in the period of welfare retrenchment, and provided legitimacy for it (Bengtson and Achenbaum 1993; Thomson 1989; Williamson *et al.* 1999). 'Generational equity' refers to the claim that some generations have benefited more than others from the welfare state as a result of institutional and demographic change. According to a simple model of correspondence between material position and attitudes, an unequal distribution of resources and costs across generations should be reflected in different degrees of welfare support: among the young and the old. Kohli (Chapter 10 in this book) shows, however, that there is not much evidence for the existence of a generational cleavage and conflict in attitudes. The connection between welfare receipt and attitudes is more complex than often assumed.

## **The contributions**

In the pension policy literature two approaches have been central. On the one hand, the political science literature has been mostly concerned with explaining institutional change through the interactions between existing institutions, policy-makers and relevant social actors. On the other hand, the sociological literature has examined the institutional structure of welfare states in terms of models for welfare provision (most often deriving from Esping-Andersen's characterisation of welfare 'regimes'), including the goals and ideas of policy-makers, governments and

society at large, and the outcomes of policy on specific population groups and cleavages (such as by gender, income or occupation). The two parts of the book are directed to the study of each of these two areas of welfare analysis.

The first part deals with the politics of pension reform. Responding to widespread concerns over the resilience of pension structures and the political costs involved in major reforms, the first four chapters of the book are all centred on a common theme: the political forces that make pension reform viable in different national and institutional contexts and the nature of political bargains, actors and cleavages surrounding policy change. In the light of recent reform processes, the contributors question the conception of pension systems as 'immovable objects', aiming to understand how institutional and political constraints can be and have been overcome.

David Natali and Martin Rhodes (Chapter 2) concentrate on the reform processes in veto-heavy pay-as-you-go systems. The authors analyse recent efforts in four Bismarckian welfare states – France, Germany, Italy and Spain – and demonstrate the centrality of negotiated bargains and trade-offs to neutralise opposition. When population ageing and increasing budgetary strains push pension system reform to the top of the political agenda, governments do in fact have at their disposition a number of tools to engage into what the authors call a 'political exchange' with the social partners in order to facilitate the passage of reform. This exchange involves trade-offs between 'policy goals', 'vote goals' and 'office goals' as key factors to get social partners' support. The outcome of this negotiated reform process is thus often not just bare retrenchment but a combination of measures aiming at financial sustainability with other measures oriented to meet some of the social partners' demands. Through an analysis of the bargaining processes in France, Germany, Italy and Spain, the authors show how this exchange has actually taken place in recent reforms. 'Policy goals' such as increasing financial sustainability, for instance, have been in the interest of both governments and trade unions, and have been partly addressed following union's demands via the financial separation of national solidarity from social insurance. 'Office goals' also appear as highly relevant in Natali and Rhodes's analysis, in particular, the consolidation of trade unions' managerial role in old and new pension schemes (as for instance in the new fully funded private funds in Germany and Italy). Similarly, long transition periods in all countries have contributed to meet 'vote goals' for the government by reducing the visibility of cutbacks and thus the negative electoral payoff. These negotiated trade-offs become crucial to neutralise opposition and facilitate the passage of reforms. In this process, the government may also be able to respond effectively to the claims of different actors for improvements in the distributive qualities of the pension system, the level of coverage and protection against risks. Thus, the authors stress a key element of reform which is not always taken into consideration in recent welfare analyses: pension reform need not be a game of 'blame avoidance' only but can also be used as a 'credit claiming' tool when some of the demands of influential social actors are introduced in the reform package, and some longstanding problems are dealt with in the process.



Martin Schludi (Chapter 3) takes a different approach to the conditions under which pension reform is made feasible. While Natali and Rhodes look at how governments can package reforms so as to get support and even claim political credit, Schludi focuses on the initial (political) conditions under which an agreement between the government, the opposition parties and the social partners is possible. He argues that the political feasibility of pension reforms critically depends on the government's ability to orchestrate a reform consensus either with the parliamentary opposition or with trade unions, and identifies the conditions under which such a 'pension pact' is likely to emerge. In the partisan arena, the feasibility of reform depends, as Schludi shows, on both 'policy distance' between opposition parties and the government (i.e. how large is the difference in their policy ideas and objectives) and 'positional conflict' (i.e. how big are the electoral incentives for parties outside the government to use opposition to reform as an electoral tool). In the corporatist arena, trade unions tend to prefer negotiated reform, which allows them to realise some of their claims in the reform process, and so does the government, which can increase the odds for reforms being approved and implemented by taking trade unions on board. The 'agreement point' (that is, the reform outcome from the negotiation in the corporatist arena) will depend on the specific position of trade unions and its distance from the status quo. As unilateral reforms are the exception, and successful reforms are usually concerted ones, this chapter, by analysing the conditions under which concertation can take place, helps us understand why some reforms are politically feasible in some countries and not in others, and within the same country in different periods of time.

The puzzle of how path-breaking reforms can actually occur is addressed from a different perspective again by Einar Overbye (Chapter 4). For him, it is neither bargaining games nor concertation processes that matter most but rather the political psychology of pension reform. Overbye argues that even path-breaking reforms are possible when they are framed in such a way as to gain support from the 'sensible' and 'socially caring' citizen. Successful reforms are those which manage to present themselves as directed towards social aims to which citizens find it difficult to oppose. The feasibility of reform is thus not only the outcome of political bargaining among social groups defending their well-defined interests. It is also the result of the way in which opinion leaders manage to present the reform as a 'socially desirable' good. This discursive framing introduces an element of unpredictability to the political scene, and makes it more difficult to assess in advance whether a specific pension reform will be politically viable. In addition to framing, Overbye highlights a number of institutional and contextual features which can increase the feasibility of path-breaking reform, including:

- 1 the breadth of coverage and the efficiency of administration;
- 2 the existence of a crisis;
- 3 the expected macroeconomic stability and interest rate levels.

Overbye argues that in Latin American countries, for instance, limited coverage and an inefficient administration have eased the way for path-breaking reforms, because reforms could be presented as a major improvement over existing systems. Administrative deficiencies in previous arrangements also tend to help radical reform, because mismanagement seems easier to deal with in defined-contribution systems, where a clear link exists between what individuals pay and receive. For the same reason, countries going through economic or fiscal crises, particularly those directly affecting pension system finances, find it easier to move out of the path, because existing systems have lost the support of their constituencies. As to macroeconomic variables, national interest rates and stable future prospects facilitate reform towards funded defined-contribution schemes because they can advertise the greater gains obtainable from private investment. Against conventional wisdom, Overbye also suggests that path-breaking reforms may, under some circumstances, be easier to pass than path-dependent ones, because in the former the definition of the winners and losers is less clear. Changing 'everything at once' may reduce the visibility of reform effects, making it easier to frame such change as socially desirable (a winner-without-loser type of outcome) than would be possible with typical path-dependent parametric reforms. While 'breaking the path' of pension policy has always been seen as a difficult avenue to take, Overbye thus argues that the opposite may be the case.

Katharina Müller (Chapter 5) takes up the political economy of pension reform in Central and Eastern Europe. She evaluates the nature of reform in transition economies, characterised by a shared context of structural change and pension financial imbalance inherited from the past. With a detailed cross-country analysis, Müller shows that in spite of this common legacy, the reform choices made in post-socialist pensions reflect considerable diversity. They include parametric changes, adoption of the new 'notional defined-contribution' system in some countries, and a shift towards funded private pension schemes in most cases. The different versions of the 'three-pillar approach' adopted across Central and Eastern Europe all share the introduction of full or partial privatisation in previously fully public schemes. Since the early 1990s, pension policy ideas started to change and a newly dominant epistemic community consolidated what has been called the 'new pension orthodoxy'. The analysis of the political context and dynamics enabling this paradigm shift provides insights into political processes that are not necessarily shared with Western Europe. International financial institutions, particularly the World Bank, have been key actors in the transmission of new ideas in old age policy. They influenced reform not only via the use of loan conditionalities, but also by offering expert-knowledge transfer and potentially attractive incentives to governments pursuing pension privatisation. Müller also highlights the policy learning and cross-border transfer of ideas occurring between Central and Eastern European countries and from Latin America. At the local level, market-oriented economists were often key agenda-setters who succeeded in communicating the reform advantages in a coherent and appealing way. Among the political actors, ministers of finance were critical



players. Ministers of labour or welfare tended to have more reservations about the three-pillar model but were less influential, which reflects the new paradigm of pension policy as an economic restructuring tool. Trade unions and governments on the left were not as clearly against pension privatisation as in many Western European countries. Some trade unions supported privatisation while left parties in some countries were also willing to support reform in order to demonstrate to the international community their commitment to market-oriented policy. The reform process became part of a ‘signalling’ strategy to gain the credibility of international organisations and risk-assessing firms. A final strategy was reform ‘packaging’. Consistent with the argument by Natali and Rhodes, Müller shows that the reforms could be used to distribute benefits to relevant actors so as to gain their support (e.g. trade unions being allowed to run their own pension funds), while at the same time using exclusionary compensations to divide the opposition and reduce the visibility of benefit cutbacks with new advantages (such as the introduction of ownership rights for individual accounts).

The second part of the book concentrates on the nature and outcomes of pension reform experiences in Europe. In the search for a solution to the financial challenge posed by growing pension budgets, both the scope and the mechanisms for public intervention have been revised, often changing the public-private mix in pension provision as well. The chapters in this section address the nature of change in terms of models, principles, ideas and discourses, as well as in terms of their effects on poverty, income distribution and gender inequality.

Camila Arza (Chapter 6) evaluates the distributional principles of pension policy, and shows how recent reforms have modified the stratification goals that have long characterised countries and pension schemes in well-defined clusters. The chapter analyses four countries belonging to different ‘worlds of welfare’ as well as to different pension system models (Bismarckian/Beveridgean), which have gone through major reforms in the past two decades (Italy, Sweden, Poland and the UK). Countries which originally embraced different welfare goals and ideas have shifted towards similar distributional principles. It is thus not just pension institutions that exhibit path-breaking, but also (to a greater or lesser extent) the principles that underpin them. A shared feature across countries has been the individualisation of pension rights and benefits. This means that benefits now depend more closely on individual characteristics, in particular, individual labour market histories and income levels. While this has reduced the inequalities deriving from special regimes and sectoral privileges, it has also reduced risk-pooling in old age: most of the risks of old age financing have been transferred to the individual. Institutionally, this was done either by increasing the share of private defined-contribution schemes in pension policy, or by redesigned public provision under actuarial principles (via NDC models). The separation of poverty prevention and income replacement in two layers has also redefined the role of the state, which maintains a major role in poverty prevention (with non-contributory, means-tested benefits expanding in all countries)

but leaves more room to the private sector in income replacement. Where the state remains important in income replacement, as in Sweden and Italy, a model of distribution which mimics the distributional logic of private pensions tends to be adopted – providing individualised entitlements dependent on individual work histories, choices and risks.

Martin Rein and Karen Anderson (Chapter 7) take the reform trajectories in three smaller countries (Sweden, the Netherlands and Denmark) as test cases for some of the key ideas underpinning most recent welfare research. First, the authors discuss the assumption of path dependence: that when setting up pension schemes, countries had to choose between the two conflicting principles of either solidarity or equivalence, and that once this has been decided, countries would continue on the same path in the future as a result of the institutional constraints for radical change. In practice, in all three countries these principles have been combined in different and original ways over time, and there has been no clear lock-in effect into one or another institutional structure. With 50 years of experience, the solidarity system in these three countries has evolved towards its own negation, that is, towards privatisation, means-testing and earnings-related equivalence policies. This reframing was not the result of a single deliberate choice made at a single point in time. Rather, the new public-private mix has resulted over time from many choices and non-choices. The authors also challenge the idea of a straightforward connection between system design or ‘welfare regime’ and policy outcomes. Through an historical analysis of the formation and change of pension policy in the three countries, they show how similar origins and different evolutions (in terms of institutional design) have produced similar outcomes in terms of the levels of poverty and inequality, as well as in terms of the public budget allocated to pensions. This implies that what actually matters is not the basic system approach but how the specificities of the programs are designed and implemented. A well designed public-private mix may manage to produce equally egalitarian results as a public-dominated solidarity approach.

Robin Blackburn (Chapter 8) is more sceptical about the potential benefits of private pension schemes. He studies the past and present of commercial pension provision in the US and the UK, two countries with among the longest (and most significant) private pension histories in the world. Through a detailed analysis of the performance of these systems, Blackburn provides a learning experience for other countries reforming their pension arrangement in the Anglo-Saxon direction. In both the US and the UK, pension benefits for future generations will be substantially below what would be needed to maintain pensioners’ relative income. This is partly due to the crumbling defined-benefit schemes, but also due to weak security markets and the high costs of private personal pensions. The author shows that employers now tend to prefer defined-contribution plans because they allow them to eliminate future risks. The fight for the maintenance of past pension promises under defined-benefit schemes puts trade unions in a difficult situation because of the impact it could have on jobs. The ‘jobs vs. pension’ dilemma highlights a key problem of commercial

pensions: the concentration of risk that emerges when provision depends on a single employer. The 'failure of the divided welfare state' is thus related to the limitations of private defined-benefit and defined-contribution schemes to provide secure, adequate and sustainable income protection for the entire old-age population. This failure shows up not only in aggregate measures of performance but in distributional outcomes as well: in both the US and the UK, a significant share of old-age households is expected to be below the poverty line, and yet another large share will receive benefits of less than half their previous income. Inequality is also related to the distribution of tax relief for private pensions, most of which goes to the tenth decile of the income distribution – the only one which is able to accumulate reasonable levels of pension wealth for retirement. Overall, the author has a clear message: 'the Anglo-Saxon model is not worthy of emulation'. If pension coverage is to be effective, it needs to move away from the commercial and individualised form.

Patricia Frericks and Robert Maier (Chapter 9) analyse the gender impact of pension reform. For them, reform has had mixed effects on gender equality, with on the one hand a better recognition of housework and child-caring in a system that, on the other hand, continues to be 'gendered', thus reproducing existing gender inequalities in the labour market. Welfare state arrangements define and implement social norms in an ongoing process of formulating what is normal. An example is the rules for pension benefit calculation, which presuppose a standardised biography still based on the male breadwinner model. The achievement of full pension entitlements depends on compliance with these norms, in particular with lifelong working careers. But real lives do not necessarily comply with this standardised ideal, and women are especially likely to have life courses which depart from it. The authors concentrate on four elements which affect future pension entitlements and are particularly gendered: labour market participation, caring, learning and the linkage between public and private pension schemes. Labour market participation is gendered for many reasons: lifelong working is less likely for women simply because of child birth and child rearing; women are more likely to work part-time and to have lower wages than men. Gender-neutral calculation norms actually contribute to reproducing the gender gap precisely because labour markets are gendered: if entitlements are strongly attached to work, and pension rules are the same for men and women, labour market differences will be immediately reflected in benefit levels. There are now counteracting elements within pension schemes aimed at reducing the gender gap in pension entitlements based on a gender-positive rather than gender-neutral perspective. These arrangements include care credits, parental leave and life course schemes, but their development is uneven across countries. The authors show that the reduction of gender inequalities in pension policy is not a straightforward task. Structural factors (such as labour market inequalities) as well as design features (the breadwinner model being used to define the pension norm) need to be addressed if pension policy is to be de-gendered; gender-neutral norms are not sufficient.

Martin Kohli (Chapter 10) discusses pension policy as a societal effort to

achieve generational equity. In the history of the welfare state, the key ‘social question’ to be solved was the pacification of class conflict. Now its place seems to have been taken over by generational conflict. The new inter-generational cleavages still need to be balanced, however, with the old intra-generational ones. This requires an examination of the concepts of age group and generation or cohort. In terms of justice theory, ageing and age group membership do not present problems; it is the discontinuity among generations which raises equity concerns. The author shows how the ideas about generational equity have been organised in public discourse, how they manifest themselves in the attitudes of the population towards the welfare state and pension reform, and how the contradictions between public discourse and popular attitudes may be explained. The discourse of generational equity – as it has developed since the mid-1980s – claims that the elderly receive an unfair amount of public resources, and that this comes at the expense of the younger population. In terms of the distribution of resources, the empirical record does not confirm this claim: while the elderly in most countries have improved their economic wellbeing over the past decades, it still remains below that of the active population. As to popular attitudes, the distributional conflict among generations is much less pronounced than is presumed (or advertised) by the proponents of generational equity. Support for public pensions is still high. There is some differentiation along the age dimension, but much less than one would expect from a purely interest-based model of political preference. The prediction (or fear) that the political agenda will increasingly be dominated by narrowly conceived old-age interests is thus not warranted. On the other hand, there is some evidence for the continued relevance of the old cleavages of class. The main explanation for this contradiction between discourse and attitudes that the author proposes lies in the generational interdependence frame. Recent research on transfers among adult family generations shows that there is a substantial downward flow of financial resources from the older to the younger generations, both as *inter vivos* transfers and as bequests. These family transfers partly depend on the availability of public pensions. Another explanatory factor is the institutional pattern of age politics.

## Conclusion

Our book thus tackles some of the key issues of recent welfare reform with new perspectives and on the basis of new empirical evidence. It reviews the concept of welfare regimes, and evaluates how and in what directions the recent pension reforms have changed the clusters as they were originally defined. These broad models can no longer be taken as appropriate indicators of outcomes. Part of the problem is the application of the overall regime typology to specific welfare domains such as pensions, where clusters may need to be cut differently (e.g. based on the Bismarck-Beveridge differentiation). The other part is that even these narrower models focused on pensions are less and less close to the reality unfolding across the successive waves of reform. A more capillary small-scale analysis is necessary to show that pension systems across countries have become

both more similar (by reducing benefits, tightening eligibility conditions and increasing the role of the private sector) and more different (by increasing the number of specific rules of benefit allocation and the number of pillars and layers in each system). There is convergence with respect to the original regime classifications, and divergence with respect to the new differentiations. Pension systems are moving farther and farther away from the ideal types embodied in regime classifications; most countries now have to be classified as hybrids.

This links up with the issue of institutional stability and change, which has been dominated by the ideas of path dependence and locked-in constraints to reform. The book demonstrates that these dominant ideas need revision. It highlights the political, social and economic conditions under which reforms can be feasible, the actors involved, and the policy instruments and mechanisms by which reforms are negotiated among them.

The idea of path dependence may have been applied too rigorously right from its inception. Past experience shows that pension policy – as welfare policy more generally – has usually been rather pragmatic and resourceful, incorporating features from competing basic designs if they promise to solve some of the problems at hand. Conceptual exchange among countries through mutual observation and learning has always occurred on a regular basis, and is likely to have increased through Europeanisation and the spread of benchmarking and best practice procedures. This policy pragmatism has been a key element of the adaptability and economic sustainability of the welfare state so far (Lindert 2004).

Another aspect of conceptual rigidity – and even reification – has been the assumption that institutional design features fully determine policies in line with the original design intentions. Against this (implicit or explicit) assumption, it can be shown that policies have turned existing institutional frameworks to new goals and uses, much more so than taking the institutions at face value would lead us to believe. As welfare systems mature, the problems to be solved change, not least through their own making. A case in point was the broad trend towards early exit from the labour force, shared by most Western countries in the 1980s and early 1990s (Kohli *et al.* 1991; Ebbinghaus 2006). This trend was brought about by policies using different institutional repertoires and turning them to a common goal through creative redeployment – a form of institutional ‘bricolage’ that often subverted the original goals that these institutions had been set up to achieve, for example, by using unemployment and disability insurance to achieve early exit from employment much before the pension system ‘as such’ could kick in.

The connection between institutional design and outcomes is highly complex on yet another level: that of the differential impact of various instruments on various social groups. Some reforms are likely to increase the future wellbeing of some groups but risk to decrease that of others. Impacts need to be systematically differentiated by gender and cohort, and to be projected against the likely evolution of life course patterns of employment and family structure.

A final contribution of the book is its concern with the issue of legitimacy,

fairness and justice, and with public discourse on this issue as part of the politics of pension reform. The book engages the 'generational equity' debate, and shows that there is not nearly as clear-cut a generational divide in people's attitudes and support for the welfare state as is generally assumed. It also challenges the assumption, basic to most political thinking on the welfare state, that the latter has created its own constituency and empowered it so that it now foils any attempt at reform. This assumption is based on too narrow a model of interest-based political preference and behaviour. Here is another instance of our overall message: that many of the received ideas need to be replaced by a richer and better grounded account of how institutions cluster, change, and influence outcomes.

## Notes

- 1 Figures are based on ILO (various years), and exclude public-sector schemes.
- 2 This is not to say that other, more structural explanations for this translation should be ruled out. The literature on welfare state expansion provides good evidence for such explanations. Fred C. Pampel (1994) has shown that from 1959 to 1986, the effects of population ageing on public spending in OECD countries varied according to whether a country had class-based corporatism and strong leftist parties. Population ageing resulted in higher spending on pensions and the aged relative to spending on families and children only in countries (such as the US) without these features. Self-interested mobilisation by age is thus more likely in countries which do not have class-based institutions that emphasise *intra*-generational over *inter*-generational cleavages and conflicts (see Chapter 10 in this volume).
- 3 Figures taken from United Nations World Population Prospects database at [esa.un.org/unpp/](http://esa.un.org/unpp/).
- 4 OECD (1988).
- 5 Excludes Luxembourg.
- 6 Data from Fondazione Rodolfo De Benedetti 'Social Reforms Database' (last updated in 2003).
- 7 Data taken from European Commission and Economic Policy Committee (2006).

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## **Part I**

# **The politics of pension reform**



## 2 The 'new politics' of pension reforms in Continental Europe

*David Natali and Martin Rhodes*

### Introduction

From the 1970s on, a series of pressures have shaken the social protection structures created and developed in Europe in the nineteenth and twentieth centuries. These include an increase in the demand for services (beyond the expansion of available resources), the transformation of the family, an ageing population, general budgetary strains (compounded in some countries by the EMU convergence criteria) and an ideological shift towards neo-liberal principles and values.

Europe's 'conservative-corporatist' regime of countries faces the most difficult combination of problems due to strong challenges to its foundational assumptions (strong and constant economic growth, full employment, family stability, a low level of female work force participation), and an institutional structure that is resistant to reform (that is, popular but fragmented social schemes financed by social contributions and managed by social partners and the state).

Pensions provide a paradigmatic case of reform sclerosis. The continent's pay-as-you-go (PAYG) pension systems are at first glance the most difficult of welfare programmes to reform. To succeed, reform proposals must accommodate or bypass a host of institutional veto points and opposing vested interests, the most vociferous of which is the labour movement, the self-appointed defender of the pensions status quo in all Continental European countries. The consequence has been a decade or more of reform blockage, interspersed with occasional episodes of reform progress, but also many examples of failure, sometimes provoking or accompanied by the collapse of the government concerned.

Yet reforms do occur, and most European countries are now engaged in an ongoing process of step-by-step reform towards greater sustainability of their pension systems, while also retaining and sometimes strengthening their commitments to system equity and effectiveness. Our objective is to present a novel understanding of how veto-heavy pension systems are reformed in this way. We demonstrate the centrality of negotiated bargains, or trade-offs, in successful European pensions reform and claim that these bargains are underpinned by a complex process of 'political exchange' that diminishes or neutralizes opposition.

We also show that the outcomes of such trade-offs are far removed from neo-liberal retrenchment; by contrast, they often respond effectively to the claims of different actors for improvements in the distributive qualities of the pensions system, extending coverage and improving protection against risks.

We begin our investigation by assessing the pension reform dilemma in Bismarckian Europe. We then lay the foundations for our own analysis in the next section. Our core argument is that pension reform proceeds in the Bismarckian welfare systems via a complex set of trade-offs in the realms of policy and politics. While blame avoidance is usually considered to be the major motive inspiring reform strategies, we claim that credit-seeking and claiming is a major spur to participation in these ‘bargains’ and a key explanation for reform success. In the final section we present our empirical analysis of the political trade-off – in terms of processes and outcomes – in four cases of reform success, in France, Germany, Italy and Spain, all members of the ‘Continental-conservative’ family of welfare states (Esping-Andersen 1990). Our primary interest lies in the ways in which the scope for policy manoeuvre and reform success in all four countries is contingent upon complex bargains, and the different ways in which it led to pension system reconfiguration and a new equilibrium between the four key system objectives of financial viability, economic competitiveness, equity in coverage and effectiveness of provision. The chapter concludes by addressing some broader implications of this study for our understanding of welfare state reform.

### **Pensions and the politics of welfare state reform**

The Bismarckian pension model is based on the overarching goal of income maintenance. As discussed by Martin Schludi in Chapter 3, financing is provided mainly by employers’ and employees’ contributions, entitlement is conditional upon a contribution record and most benefits are earnings-related. Public pension schemes are organized on a PAYG basis and funded by compulsory contributions that are not capitalized, but immediately employed to cover payments to current pensioners. As for management, there is a mix of responsibilities between the state and organized interests: the state has a supervisory role (especially regarding the system’s financial viability) while many decisions are negotiated with trade unions and employers’ organizations.

The intense political debate on recasting pensions in Continental Europe has centred on four broad issues: *financial viability* (the financial imbalances of social security programmes are one of the main challenges and have obliged policy-makers to reduce social outlays and increase contributions); *economic competitiveness* (financial problems have been related to general economic difficulties, including a low level of annual growth and relatively low levels of employment, to which Catholic familialism and labour market rigidities have contributed) (Esping-Andersen 1996); *equity* (equity problems derive both from the uneven distribution of protection and costs between social and occupational groups, and differences in funding resources between the various social

programmes); and *effectiveness* (part of the dilemma for policy-makers is how to reorganize welfare programmes to reduce financial imbalances while also improving their 'cover' of different – both old and new – risks).

Tackling these problems also means engaging with what Pierson (1996, 2001) has called the 'immovable objects' in the path of reform. Virtually every citizen has a stake in public pensions. Current pensioners as well as future beneficiaries are likely to object to new measures that diminish entitlements. Support for current pension programmes thus remains intense and creates potentially strong opposition to reform. Such opposition in Continental pensions systems can be expressed via two different channels: the electoral and the corporatist. And yet reform does occur.

Much has been written on welfare state retrenchment, stressing the inability of policy-makers to reduce social outlays. However, as others have shown, rather than aiming simply to retrench welfare spending, policy-makers have also sought to reorganize welfare institutions and programmes and modify – sometimes positively – their distributive outcomes (for example, Ross 2000; Hering 2002; Palier 2002b). Following Rhodes (2001), we argue that the coexistence of different priorities can increase the opportunities for innovation, and even for painful policies, including cutbacks. The more reform dimensions there are, the more opportunities exist for 'trading' them with one another. In any given country, the room for policy manoeuvre depends on the nature of such interaction. In all of the countries in this study, commitments by actors to different 'ideal' reform packages provide the basis for trade-offs in which both political and policy goals are subject to a particular form of 'political exchange'.

In the following analysis we make three major claims. First, the notion of 'cost containment' needs to be contextualized, since many of the measures proposed to restore financial viability consist not of cutbacks but of increased funding for particular social programmes (see also Anderson 2001). From the 1980s onwards, there have been moves to distinguish more clearly between social insurance benefits and non-contributory benefits. This strategy allows policy-makers to reduce social insurance deficits while also ameliorating the impact of social contributions on labour costs. The overall orientation of reform is therefore less towards cost-containment as such but rather the restoration of financial viability in pension programmes via a range of alternative options.

Second, instead of focusing on the strategy of 'blame avoidance' to reduce the social and political risks associated with reform (Weaver 1986; Pierson 2001), we argue that a much more complicated game is being played between policy-makers, voters and vested interests, and that recasting welfare programmes frequently involves 'credit claiming' as well. Some measures (for example, cost-containment) do indeed imply the need to reduce or diffuse blame. But others can be defined as classical credit-claiming acts. The introduction of supplementary, fully funded schemes is a good example of a credit-claiming exercise (Schludi 2005). The government thereby avoids an increase in contributions to public pension schemes, the living standards of beneficiaries are safeguarded, and since such schemes are usually implemented through generous

tax incentives, they can be presented as additional to, rather than simply replacing, other benefits.

And third, because ‘positive-sum’ outcomes are still possible despite the diminished resources available for traditional forms of corporatism, we argue that ‘political exchange’ can play a major role in resolving distributive conflict in the contemporary period. When welfare state recalibration is at stake rather than outright retrenchment, then the range of reform options and scenarios remains much wider, facilitating redistributive bargains.

### **Understanding pension reform: interests, preferences and trade-offs**

The broadening of social bargains has been a key factor in reinforcing concertation trends in recent years, especially in those countries where the organizational prerequisites for corporatism have been weak (Rhodes 2001; Molina and Rhodes 2002). By coordinating different policy sectors (and/or different bargaining levels) policy-makers can extend and reinforce concertation. An extended and iterated process of exchange allows key policy actors to interact with each other and to negotiate and adopt reforms with reduced electoral and social risks.

We can apply a similar logic to studying the construction of reform coalitions in pensions. In many mature PAYG systems it is essential that policy-makers gain at least the tacit consent of organized groups in advance of reform. Reform proposals in such systems usually take the form of policy packages for building consensus. In the four countries of this study, engaging in complex and novel processes of ‘political exchange’ has been decisive for securing support for reforms. Reforms, in successful cases, are the result of trade-offs involving a series of policy goals. In our analysis below, we demonstrate that recasting pensions usually involves a complex set of such political trade-offs.

But who are the key actors involved in the process? While in some countries the electoral arena is the most important for defining reform initiatives, the corporatist arena is decisive for recasting Bismarckian welfare states. We focus here on the role of labour organizations. For while employers’ influence on the agenda for pension reform may have been decisive, their support is less critical for the adoption and implementation of proposals. By contrast, and notwithstanding their declining resources, in many countries trade unions still play a critical role in introducing new pension provisions (Myles and Pierson 2001; Natali 2004a). They act and are perceived as the main defenders of welfare programmes. They participate in a more or less institutionalized manner in both policy-making and policy-implementation and have multiple interests to defend (Béland 2001; Boeri *et al.* 2002; Natali 2004b).

But what are their policy preferences? Political parties and social actors have multiple goals. Parties are often depicted as driven by the need to make electoral gains or minimize losses. Social actors (unions) are assumed to be wedded to the status quo. But a recent literature has demonstrated that party leaders have a



more complex set of parallel preferences and goals. We argue that the same insight can be extended to the leadership of labour organizations. In line with our discussion above on the complexity of reform agendas, these goals can be mixed and 'traded' to enlarge the opportunity for innovative change.

Rosa Mulé's (2001) analysis of political parties and income redistribution defines party behaviour as 'many-sided and multifarious'. Contesting earlier models that assumed that different aims were mutually exclusive, Mulé argues that politicians adopt a plurality of strategic moves in competition with one another. Parties can be depicted as:

- *vote-seekers*, in trying to gain votes and control government;
- *office-seekers*, in expanding their control over political office in their quest for benefits and private goods;
- and *policy-seekers*, in their quest to represent particular groups, in line with social or other kinds of cleavage.

Of course, in reality, these goals overlap and are pursued simultaneously. But they do enter differentially into actors' calculations of relative gains. Thus policy aims will range from maximalist, ideologically-driven positions all the way through to minimal aspirations, allowing major concessions to be made in bargains if other goals (in retaining votes or office) can also be achieved. Politicians can present policy packages that are less than ideal from a party-platform point of view to their constituents, while also retaining their support if other gains can also be demonstrated.

Social partners assume similar roles when they are active in the broader political domain. Trade unions defend their rank and file interests and their own organizational demands. In doing so their aim is not just to defend a particular social model but also to maintain key resources of legitimacy and organizational power. When it comes to pensions and pension reform, not only do labour organizations defend their managerial role in social insurance programmes (as office-seekers), but they also engage (as policy and vote-seekers) in promoting the interests of their own members and the political parties with which they have ties.

As pursuers of plural strategies, we argue that policy-makers have a larger margin of manoeuvre than is traditionally understood since policy goals can be traded against one another. This makes political exchange possible. For example, the defence of the social partners' administrative role (as office-seekers) can be traded with measures for increasing the financial viability of the welfare state. In other instances, the labour movement's priorities as policy-seekers and vote-seekers (for example, in defending the interests of current pensioners and older cohorts of employees) can be traded with concentrated losses on less-represented groups (for example, younger cohorts and private sector employees), thereby mitigating their veto-player role. Thus, even the 'immovable' aspects of current welfare programmes can be transformed into positive tools for policy-makers in arranging new reform packages.

## **Pension reform bargains: four case studies**

### ***France: a 'pre-emptive' trade-off***

Since the early 1990s, mounting deficits and perverse labour market effects have highlighted the need for reform in France. The financial burden of the welfare state has been mainly concentrated in the pension sector. But public opinion has proven to be strongly attached to current pension arrangements. Until 1993, various marginal measures (*Plans de redressement des comptes de la sécurité sociale*) were limited to increasing contributions to balance the social budget (Palier 2002a). Attempts to realize a general reform of the pension system were blocked.

At the beginning of the 1990s, the debate on pensions was centred on the Socialist Rocard government's 1991 White Paper. Both left-wing and right-wing parties agreed on the following:

- 1 The need to strengthen and adapt the French model of capitalism to new international circumstances due to economic stagnation and a high rate of unemployment.
- 2 That the French welfare state was a source of social exclusion and ineffective in helping system outsiders (Natali 2003).
- 3 The need to reduce social security deficits. These could no longer be corrected simply by increasing social contributions (Palier 2002a).
- 4 The need perceived by some politicians and bureaucrats to reduce the role of the social partners. Their managerial role was increasingly seen as a source of inefficiency and increasing welfare costs.

Policy-makers proposed different measures to improve the financial sustainability of pension schemes: an increase in the number of contributory years for a full pension, lengthening the period for calculating the reference salary, and less generous indexation mechanisms. The White Paper also advocated the introduction of an Old-Age Solidarity Fund (FSV) to finance non-contributory benefits (formerly financed from social contributions) through general taxation, thereby reducing the burden of social charges on labour costs. Other proposals concerned the introduction of fully funded schemes and the harmonization of different pension schemes in the interests of greater system equity.

The trade unions proposed a very different set of solutions and were much less concerned with the state of the social security deficit. The anarco-sindicalist *Force ouvrière* (FO), for example, argued that the deficit was the result of inadequate financial contributions from the state, calling for a clearer separation between contributory and non-contributory benefits. The causal relationship between welfare inefficiencies and the high rate of unemployment was reversed: unemployment was depicted as the *cause* of low levels of contributions and financial problems. The unions' reform agenda was based, instead, on a defence of the co-management of social insurance programmes by the social partners

(that is, the pursuit of office interests), the introduction of a solidarity fund for financing programmes through taxation (financial viability), and the rejection of both fully funded schemes and a reduction of benefits (cost containment). The more reformist CFTD (*Confédération française démocratique du travail*) was more open to the need for innovative reforms (Natali and Rhodes 2004).

The main issue in the French reform debate was the need to increase economic competitiveness by reducing the burden of social contributions. The reduction of social insurance outlays was seen by political actors as fundamental for increasing the financial viability of the system, while labour leaders wanted to redefine the relationship between national solidarity and social insurance and maintain the traditional character of pension institutions.

Historically, the relationship between social partners and the state in France has been particularly difficult. Institutional weaknesses and the ideological fragmentation of the labour movement have made it difficult to achieve a genuine social dialogue. This was as true of the 1990s as it was of previous decades when agreements between the government and social actors on pensions proved to be impossible (Labbé 1996). The formal meetings that did take place resulted in neither formal negotiation nor constructive dialogue. The French state seems condemned to act unilaterally and incapable of avoiding blame (Levy 2001).

Nevertheless, in the early-to-mid 1990s, the Balladur government formally expressed the need for a broad collaboration between the government and social actors. However, the unions reacted negatively, with particularly strident opposition coming from FO and the communist CGT (*Confédération générale du travail*). In response, the government adopted a 'leaner' strategy. Apart from a number of formal meetings with the social partners, Balladur acted unilaterally in creating a reform that would trigger the least degree of opposition from the unions. The reform therefore sought to pre-empt the veto powers of the latter while also seeking remedial action in tackling the crisis of the French welfare state (Natali and Rhodes 2004).

Unlike in our other three cases below, where, as we will see, the trade-off was the consequence of active concertation, the Balladur reform can best be characterized as a 'pre-emptive' trade-off. In other words, it sought the tacit consensus of the social partners without actually engaging them. This consensus was decisive for the adoption of a pension reform in the summer of 1993. It had three main elements:

- 1 A first measure consisted of setting up the FSV (*Fonds de solidarité vieillesse*). The aim was to charge non-contribution-linked expenses (previously covered by the pension regimes, with resources obtained through contributions) to the national solidarity fund and finance them from general taxation. This was also one of the labour movement's major proposals.
- 2 To reduce the system's costs, the criteria for measuring pension benefits were modified. The number of contributory-years needed to gain a full pension was increased from 37.5 years to 40, as was the reference period for

calculating the average annual (reference) wage. The reform also modified (in a more restrictive cost containment sense) the indexation criteria for calculating pension benefits (Blanchet and Legros 2002).

- 3 As for the *Sécu*'s administrative and financial organization, the unions' position as managers of the system was guaranteed, allowing them to retain their key organizational resources.

Under the trade-off, the new old-age solidarity fund was directed to the reduction of financial strains and decreasing the burden of social contributions. Other measures (new mechanisms for the calculation of pension benefits) were introduced as cutbacks. Yet, by increasing the link between contributions and benefits they transformed the pension system in line with actuarial principles. The reform package was more than just a carefully targeted reform, introduced via a '*méthode douce*' (for example, Vail 1999), but it was also less than a full quid pro quo (cf. Bonoli 2000: 149). It was rather the result of a complex, 'pre-emptive' trade-off between different policy goals (Figure 2.1).

On the political side of this pre-emptive trade-off, the government adopted measures to reduce the financial burden of pension schemes and to maintain the traditional logic of social protection *à la française*. Acting as a policy-seeker, the government sought to combine these efforts with measures for increasing economic competitiveness via the reduction of social contributions. The reform also sought to avoid protests from public opinion in general and by union members in particular. Balladur thus obtained the acquiescence of the labour movement by maintaining their organizational resources (satisfying the unions' office-seeking goals), and reducing as far as possible the impact of new provisions on their members (allowing them to pursue their vote-seeking ambitions). The latter objective was achieved in two ways. First, the government introduced changes through a gradual transition that shifted the impact of the reform away

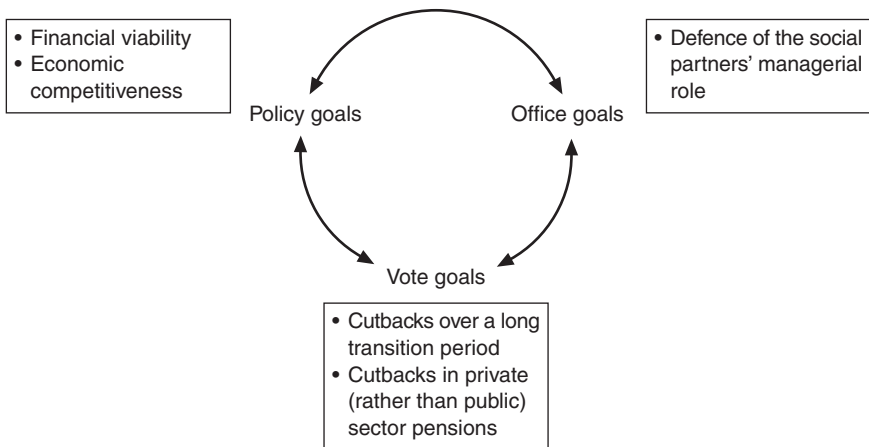


Figure 2.1 The Balladur reform's 'pre-emptive' trade-off.

from the more unionized, mature worker cohorts and on to less unionized younger employees. Second, the reform concerned only the less unionized private sector workers and did not affect their more unionized public sector counterparts, thereby limiting the risk of blame for both political and social policy-makers (Natali 2003).

As for the effects of the reform, it was a typical case of path-dependent change. There were no particular innovations concerning the mode of financing, the benefit structure or administrative control. All of the new measures were consistent with the logic of the existing social institutions (Palier 2002a). As regards their impact, the new plans have been implemented incrementally over a long transition period and all of the above-mentioned provisions were adopted for the general regime (covering private sector employees only) but not – significantly – for the special regimes covering public sector employees. In a country where the unionization rate in the private sector is 50 per cent lower than in the public sector, this was clearly an attempt to mitigate any hostile reaction or veto on the part the latter's powerful trade unions (Labbé 1996).

### ***Germany: forging an innovative reform***

At the beginning of the 1990s, Germany was an example, par excellence, of the 'Bismarckian disease'. Two interrelated threats were perceived as particularly dangerous for Rhenish welfare capitalism: the declining competitiveness of the German economy and increasing financial strains on pensions due to population ageing (Ney 2001).

The unsatisfactory evolution of the labour market and the increasing social contribution rate were seen as undermining Germany's capacity for economic adjustment, generating a vicious circle of employment decline and rising benefit costs. The use of early retirement and disability pensions as a tool for labour market adjustment only aggravated the system's dependency ratio between beneficiaries and contributors (Manow and Seils 2000). The unification of East and West Germany produced a parallel debate on its effects on pension financing. The extension to the new *Länder* of Western pension rules was considered the main cause of instability in the social insurance budget, producing further strains on the economic and financial viability of the welfare state as a whole. A third issue in the reform debate concerned the inter-generational equity problem facing younger cohorts (Hinrichs 1998).

While in the other European countries political actors now had similar priorities amidst a growing consensus on the need for reform, in Germany the views of the major actors had actually diverged by the 1990s. Social-democratic modernizers (represented by Prime Minister Schröder and Minister of Labour Riester) proposed to stabilize (or even reduce) contribution rates and to balance pension budgets through cutbacks, increasing the flow of resources from general taxation, and extending the pension net to flexible and independent workers (thereby increasing the revenue base and improving equity). Retrenchment measures would involve new indexation mechanisms and a general reduction in

benefits. The decline in the replacement rate would require an extension of other forms of pension provision, namely a second pillar based on market capitalization (Hinrichs 2005).

Traditionalist Social Democrats and trade unions opposed the introduction of supplementary fully funded schemes as a source of prohibitive burdens on contributors and a threat to the general PAYG scheme. The unions feared an associated loss of organizational power because such schemes would be beyond their control. They proposed instead an increase in funds rather than cuts via an extension of insurance coverage to system outsiders and increasing federal grants to finance all non-contributory benefits (Leisering 2001; Seeleib-Kaiser 2002).

The Social-Democratic government put the 'pension problem' at the top of its agenda. But the reform was finally adopted only after considerable conflict between different political and social actors and within the governing coalition. Led by the prime minister, Gerhard Schröder, the modernizers initially tried to reach a compromise with the right-wing opposition, and then sought the agreement of their own traditionalist MPs. The result was a quid pro quo reform based on a coalition of left-wing MPs, trade unions and a heterogeneous majority in the upper House (*Bundesrat*) (Schludi 2005). As a trade-off, the 2001 pension reform consisted of different measures targeting two main policy goals – the introduction of benefit cuts and the promotion of private pension funds:

- 1 First, the standard pension level was reduced for all pensioners through cut-backs for new beneficiaries and new indexation rules for existing ones. Thus, pension cuts were lower than initially proposed by the government and safeguarded the benefit level for younger cohorts of workers as requested by the unions (thus striking a compromise between the goals of financial viability and inter-generational equality).
- 2 While the first draft of the reform proposed mandatory, fully funded private schemes, the final version approved introduced subsidies (i.e. tax deductions) for non-compulsory private funds. A further concession made by the government to the parliamentary opposition and unions proposed that the new supplementary funds be managed through collective agreements, thereby defending the managerial role of the social partners (and thus meeting the unions' office-seeking aspirations) (Anderson and Meyer 2003).
- 3 Before the general reform, the government implemented other measures to increase the role of the federal grant and reduce the contribution rate (thereby increasing revenues and economic competitiveness) and suspended the indexation of pension benefits to net wages (enhancing long-term system sustainability).

The 2001 *Rentenreform* took the form of a trade-off constructed by the unions and the government, each pursuing multiple objectives (Figure 2.2). The cost-containment measures (which were massively reduced compared to the government's first draft) were defined so as to guarantee the living standard of future

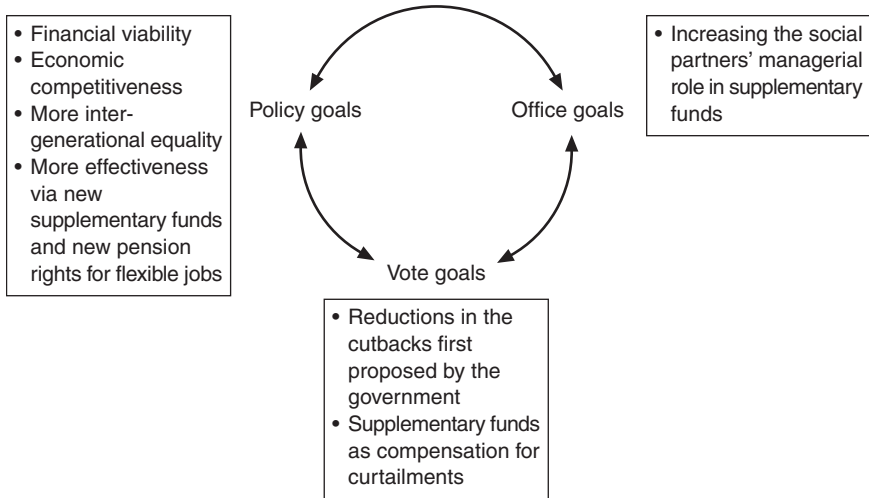


Figure 2.2 The trade-off in Germany, 2001.

recipients and the administrative role of the unions was also thereby strengthened. The Schröder reform's cost containment measures were quite similar to those of the failed Kohl reform of 1999 (Schludi 2005). But it encountered a lower degree of opposition because its benefit curtailments were perceived as less intense. Countervailing measures reducing the real level of decline in public benefits were important in pre-empting labour protests. Opposition was also defused by the introduction of supplementary funds, a positive-sum solution that also guaranteed new powers and organizational resources for the unions (office-goals).

In terms of impact, the new plans have begun to modify the nature of the pension system (in a more radical sense than in France), but have had a more limited effect on pension expenditures. Even innovative changes can be implemented with the consent of vested interests if they do not have a huge impact on their most sensitive claims. Cutbacks were implemented together with a reduction in contributions (in line with the priority of the modernizers) but to a lesser extent than originally aimed for by the government (Anderson and Meyer 2003). At the same time, other measures increased revenues (through new taxes) for funding non-contributory arrangements (in line with traditionalists' demands).

### *Italy: a quid pro quo exchange*

By the beginning of the 1990s, Italy had already long experienced unbalanced growth in social contributions and outlays: the latter continued to rise while revenues stagnated (Ferrera and Gualmini 2004). At the same time, current expenditure was growing rapidly and was financed from the public budget (and



deficit). Exogenous developments in the international economy and the imperative of joining EMU forced Italian policy-makers to adopt a retrenchment strategy targeting the public sector deficit and debt.

Political and social actors had to come to terms with the need for reducing financial stress. New right-wing movements (the Northern League and *Forza Italia in primis*) provocatively proposed path-breaking measures along the lines of the Chilean model, while their left-wing counterparts advanced rather marginal measures for reducing deficits and distributing the burden fairly between different socioeconomic groups. But all agreed on the need to introduce market-oriented mechanisms, by increasing the relationship between contributions and benefits, and introducing new fully funded schemes to maintain the average level of coverage after retrenchment (Natali 2003).

The issue of equity was also high on the reform agenda due to differences in entitlements between occupational categories, in particular those between self-employed workers and employees and between private and public-sector employees. Other problems included the high level of fraud and benefit abuse due to inefficient institutions. Moreover, as in the French case, welfare arrangements and institutions were perceived to be less and less competitive in an increasingly global market, as reflected in economic stagnation and a high rate of unemployment. After a long period of policy sclerosis, in the early 1990s, economic crisis was compounded by extensive political turmoil (related to the end of the 'First Republic' and the beginning of judicial investigations into political corruption), which enlarged the window for reform, allowing Italy to embark on a new and 'winding road to adjustment' (Ferrera and Gualmini 2004).

We focus here on the pension reform adopted in 1995 by the Dini 'technocratic government' (supported by a left-wing parliamentary majority) which followed the first, and more limited, Amato reform plan of 1992 and the failure of the Berlusconi reform in 1994. This new plan was the most ambitious to be approved to date in Italy (Ferrera and Jessoula 2005). All key actors in the policy-making network by now agreed on the need for an innovative rather than marginal consolidation of the pension system.

The main priority for the government was an improvement in financial viability. The challenge was to distribute the financial burden of reform in such a way as to defend the under-protected categories of the population (thus meeting the objectives of both equity and effectiveness). The main proposal was the introduction of new formulae for benefits calculation for both old age and seniority pensions – in other words, benefits paid to workers on the basis of a certain period of contributions, regardless of the age of retirement. The government also planned to make the supplementary schemes introduced by the Amato government in 1992 more effective, and better able to compensate for the diminished role of public schemes. The trade unions, on the other hand, stressed the importance of protecting 'acquired rights', that is, the pension entitlements of the mature cohort of workers (those about to retire) and present pensioners. They also proposed new plans for reducing contributory fraud and for increasing the



weight of contributions for particular categories (the self-employed and public employees). Finally, they agreed that supplementary schemes should be reformed. In this respect, the unions were acting as both office- *and* policy-seekers. They saw supplementary schemes as a means of increasing their administrative role (and, they anticipated, for 'democratizing' Italian capitalism), as well as a source of benefits for compensating losses in the first pillar of the pensions system (Lapadula and Patriarca 1995).

In 1995, the reform process developed according to a logic quite similar to that of the earlier Amato and Ciampi reforms (Natali 2004a). The relationship between the government and unions had become more stable and constructive than in the past, and was able to withstand an intensive phase of bargaining. During the months that separated the beginning of the pension reform negotiation from its conclusion in May, union experts and Ministry of Labour advisors jointly developed the parameters of change. The final project was essentially based on union proposals (Natali and Rhodes 2004).

Exceeding the limits of the Amato reform, the 1995 reform aimed to render the system more sustainable and fair, while also adjusting it to the modern world of work and the evolving Italian economy. The precise goals were the reduction of privileges between different social insurance schemes, and the further promotion of pension funds and changes to benefit formulae. In a marked departure from previous experience, the reform also sought to increase the flexibility of benefits provision to cover the least protected sections of the work force.

- 1 The benefit structure was modified to control costs (financial sustainability), setting aside earnings-related formulae in favour of contribution-based formulae, thereby strengthening the system's social insurance principles. The plan also introduced a flexible-retirement age (from a minimum of 57 to a maximum of 65) by calculating benefits in a progressive manner, even if this was clearly a cost-containment measure.
- 2 Further interventions favoured by the unions included a sharper distinction between national solidarity and social insurance and the enlargement of the latter to cover to new forms of employment (occasional, discontinuous, temporary etc.). Obliging flexible workers to pay contributions also extended the contributions base, thereby increasing revenues.
- 3 To increase system equity, public and private-sector employees were obliged to contribute to the scheme in equal measure, while self-employed workers' contributions were raised.
- 4 Seniority pensions were not completely eliminated (at least not with immediate effect). New calculation rules (which were more restrictive but also fairer) were introduced, but over a long transition period (Natali 2003).

As elsewhere, the reform was achieved via a political trade-off: the government was able to reduce financial imbalances and improve the effectiveness and equity of pension schemes (policy goals), while the unions gained new sources of organizational power under the new regulations for supplementary funds

(supporting their office interests). The implementation of the new measures over a long transition period, and the targeting of cutbacks on social groups *not* represented by the major labour confederations, were decisive for securing reform consensus and thereby the ‘vote goals’ of both social and political actors (Figure 2.3).

In policy terms, the trade-off involved all four dimensions of current concern: *financial sustainability* (through both cutbacks and new sources of finance); *equity* (the burden of new measures fell on former privileged groups like the self-employed); *effectiveness* (a more flexible pension net covering both insiders and outsiders); and *economic competitiveness* (by distinguishing non-contributory from contributory benefits). However, there were inevitably losers, notably the younger generations. The reforms decreased benefit levels for the younger, present and future cohorts of workers, while mature employees (in particular those in the public sector) retained their social rights and incurred no significant reductions in benefits. Only some of the measures needed to balance the pension budget were adopted. These therefore represented the first step – but not the decisive one – towards fully renovating the Italian welfare system.

The new plan reduced benefits, recalibrated the entire system (to deal with new social and economic challenges), and created a multi-pillar structure by introducing fully funded supplementary schemes. From an institutional point of view, the reform was therefore innovative. The new provisions transformed the old institutions from a ‘welfare without work’ regime to an ‘employment friendly’ model (Palier 2002b). Together with the transformation of the benefit

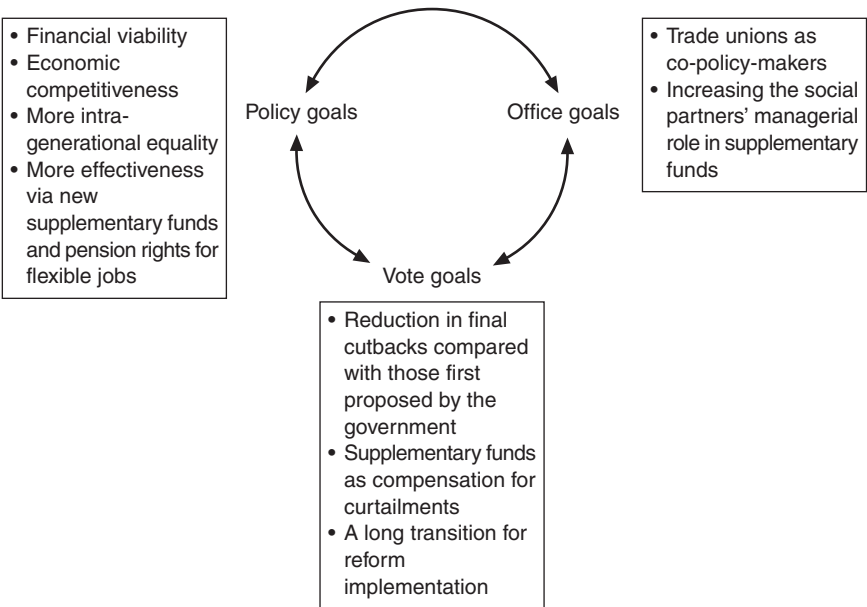


Figure 2.3 The trade-off in the Dini reform, 1995.

structure – from an earnings-related to a contribution-based system – new provisions were also defined for supplementary occupational schemes.

Although the most incisive Italian reform to date, its cost-reducing impact was rather more modest. This was the price for avoiding the crisis provoked by the Berlusconi reforms of 1994 which would have seen more radical new rules for seniority pensions (Natali and Rhodes 2004). Moreover, to preserve the acquired rights of the more mature cohorts of workers, the new legislation provided for a longer transition period that exacerbated the differences of treatment between new and older generations of workers. However, serious efforts *were* made to reduce the uneven distribution of benefits and contributions between insiders and outsiders – a reform that was either much more limited or non-existent in our other three cases.

### ***Spain: an incremental, path-dependent reform***

In our final case, Spain, the Socialist government introduced a pension reform unilaterally in 1985, but by the 1990s there was consensus among all political and social actors on the need to consolidate the social insurance system. The debate on pensions was characterized by an apparent paradox. For while the Spanish welfare state had yet to reach the same level of development (even in terms of spending) of other, more economically advanced, European countries, by the 1990s its social security budget was experiencing similar financial difficulties. Pensions were the main problem (Noguera 2002). The main issue for both political and social actors was financial viability. Demands were also being made for an improvement in the levels of certain benefits due to increasing inequalities between risks – some of them (old age) being relatively well protected, while others (for example, widows and orphans) were insufficiently covered (Chulià 2000).

The official statement of this broad consensus was the 'Toledo Pact', approved by the Chamber of Deputies in 1995. This agreement provided a *quid pro quo* basis for further reforms. As far as pensions were concerned, several recommendations emerged from a compromise between those promoting viability and those who favoured higher spending. As elsewhere, a clearer distinction between solidarity and social insurance was advocated to improve financial viability. Other proposals involved the creation of a reserve fund with surpluses from contributions, an increase in the retirement age and the introduction of supplementary schemes. A second set of proposals aimed to improve the equity of the system by changing the resource base (harmonizing contributions among schemes and reorganizing public pension programmes into two main schemes), and improving the balance of cover across risks. A third group of proposals focused on improving administrative effectiveness to combat fraud (Blanco Angel 2002).

Political parties (even the conservative Popular Party) supported the introduction of a reserve fund (which shifted funding from social insurance towards general taxation); cost-containment (a delay in the retirement age and a better

ratio between contributions and benefits); increases in certain areas of spending (more favourable indexation mechanisms); and a reduction in inequalities between contributors (Herce and Pérez-Díaz 1995).

The trade unions shared the concern of political parties with demographic trends and the high level of unemployment as well as the more dysfunctional aspects of pensions resourcing and spending. However, they also believed that social institutions should be consolidated rather than radically transformed. They supported many of the reforms advocated by the parties, including combating benefit abuse. But they rejected increases in the retirement age and in the period of contributions, and called for higher spending on widows and orphans (thereby improving equity between risks) (Guillén 1999).

The 'Toledo Pact' was drawn up by an all-party committee and proposed a gradual reform to guarantee the sustainability of the Spanish welfare system. It subsequently received the support of both trade unions and employers' organizations (Pérez-Díaz *et al.* 1995). It was followed by a general 'Agreement on the Consolidation and Rationalization of the Social Security System', negotiated by the Aznar Conservative government with the unions, which was drafted into law by the Spanish Parliament in 1997 (Lagareza Pérez 2000).

The two principal objectives of the 1997 Reform Plan were a separation of different sources of finance and a reduction in the level of certain benefits, alongside with an expansion of others. Specifically, this was achieved by:

- 1 Establishing a clear separation between national solidarity (non-contributory benefits) and social insurance (contributory benefits), which aimed to tackle social insurance deficits without increasing social contributions or cutting benefits, while also reducing the burden of social charges on labour costs (thereby improving economic competitiveness).
- 2 Creating a reserve fund to meet the system's future financial needs (which increased revenue). To contain costs, new formulae for calculating retirement pensions were introduced which increased the period of contributions and lowered final pension pay-outs, thereby improving the actuarial relationship between contributions and benefits. All were consistent with the goal of making pension programmes financially sustainable.
- 3 Introducing other measures that increased minimum pensions for survivors and orphans (thus improving 'solidarity' or equality between risks) and (in the interests of system effectiveness) maintained the purchasing power of pensions via more favourable methods of annual indexation (Blanco Angel 2002).

In sum, 'by combining expansion and expenditure cut measures, these reforms [tried] to make social and economic aims compatible so as to obtain an operative consensus' (Chulià 2000).

As for its impact, the reform did not change the nature of the system as such. It was both path-dependent and incremental (see Figure 2.4). It contained a mix of measures to reduce financial strains, to introduce greater proportionality

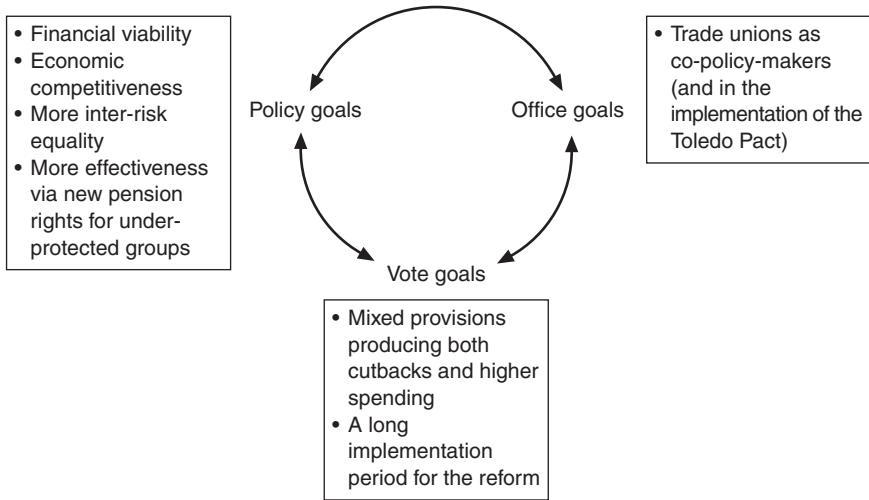


Figure 2.4 The trade-off in Spain.

between benefits and contributions and to develop more of a 'market logic'. The financial effects of the reform were limited and only delivered results over the long-term (Chulià 2000). The main goal of the new provisions, following the guidelines set out in the 'Toledo Pact', was to ensure the future stability of the system rather than its radical transformation.

But as in the other cases in this study, the reforms introduced in 1997 (and later in 2001 when further changes deepened the logic of the earlier reform) were the result of a political trade-off. The main goal of the new provisions, following the guidelines set out in the 'Toledo Pact', was to ensure the future stability of the system rather than its radical transformation (policy interests). The more favourable economic context of the period was exploited to shape a 'blameless' reform project. In particular, economic growth and the decline in the rate of unemployment favoured the adoption of measures which expanded the system in favour of under-covered groups (outsiders). While in other countries the reduction of inequalities focused on inter- and intra-generational aspects, Spanish policy-makers focused on equality between different risks. The long phase-in period for its introduction reduced risks for political and social opposition (vote goals). Finally, through a broad concertation, the government recognized the role of social partners in the policy-making process, thus meeting their 'office' interests.

### Conclusions: the (not so narrow) path to reform in Bismarckian countries

Our study of pension reform suggests several broad conclusions about the new politics of pensions in Bismarckian welfare states. The first relates to pension

policy networks and reform goals. Bonoli (2000: 37–38) was the first to recognize that the main cleavage in Bismarckian pensions policy has been less within the party system, but rather between political actors and social partners. This insight is confirmed by our analysis. With the exception of Germany, the policy-making process has been gradually de-politicized during the last decade, providing some partial support for arguments that partisan effects on social expenditure have declined (for example, Pierson 2001; Kittel and Obinger 2003; cf. Korpi and Palme 2003 for an opposing view).

Thus, the corporatist arena has been the main locus for negotiations and union consent decisive for successful reform. In three of our four countries (all except Spain), when policy-makers' efforts to recast pensions were supported by trade unions, new laws were approved. But when governments tried to reform unilaterally (the 1994 Berlusconi plan in Italy, the 1995 Juppé reform in France and the 1999 Kohl *Rentenreform* in Germany – which received parliamentary support but was never implemented) they failed. On all of these occasions, trade unions acted as reform-blocking veto players. In Spain, by contrast, the labour unions were unable to veto a unilateral Socialist government reform in 1985, due to institutional fragmentation and a weaker representation of retired workers than in our other countries. But they did become key policy-making partners from 1997 on when the Popular Party government sought to enhance the social legitimacy of its reform programme via concertation.

A second set of conclusions concerns the nature of the political trade-off in pensions and its contribution to enlarging the path of reform. As we have shown, the major actors simultaneously pursued parallel objectives that we characterize, following Mulé (2001) as policy-seeking, vote-seeking and office-seeking goals. Policy-makers acted as 'creative opportunists' in pursuing these complex reform processes and bargains, using all means available to expand their room for manoeuvre. In the political trade-offs, the parameters of reform were shaped by debates over financial viability, economic competitiveness, equity and effectiveness. With trade union support, policy-makers arranged a mix of such goals within reform packages. The array of measures used to achieve financial viability shows how such room for manoeuvre can be gained. Policy-makers still have two options for balancing pension budgets: to increase revenues and reduce costs. By introducing measures that clearly distinguished between social insurance benefits and non-contributory benefits, they engineered a shift in the burden of financial responsibility from social insurance to the public budget. Other measures sought to respond to gaps in employment (for parental leave, unemployment etc.) and expand insurance coverage to excluded groups. Such measures were used to mitigate the impact of cutbacks by redefining pensions as a public good. As a result, while recasting welfare programmes is generally presented as a blame avoidance exercise (Pierson 1996, 2001), we argue, by contrast, that more often than not it combines both credit claiming *and* blame avoidance strategies.

While taking a different form in each case, the equity objective provided particularly important opportunities for trade-offs in all of them. Policy-makers

could introduce, redistribute or subtract provision to increase equity in exchange for support for their own policy goals. The corresponding acceptance of innovative change by defenders of the welfare status quo is particularly striking. In Italy, trade unions even agreed to enlarge the role of supplementary, fully funded schemes as part of a quid pro quo to reduce the negative impact of cutbacks. Improving the effectiveness of pension programmes also allowed actors to claim credit. This strategy was especially useful for policy-makers in Southern Europe where, because of a highly inefficient welfare administration and related problems of widespread benefit abuse and fraud, a lack of effectiveness was perceived as one of the most important threats to the future stability of welfare institutions. The same goes for other innovations, including the implementation of a supplementary private pension pillar, one of the most innovative reforms in Germany and Italy in the current period. Although we lack strong evidence to support this point (which future research will need to provide), we assume that, facilitated by tax incentives for contributors, the introduction of a supplementary pillar was as likely to produce credit from the electorate as it was to incur blame. It was certainly presented by the unions to their membership in this spirit.

In sum, the scope for claiming credit has proven to be of critical importance for securing trade union involvement in political trade-offs. Unions have behaved as office-seeking strategists in this process. The trade-off between the defence of the office goals of labour organizations and the adoption of new pension provisions has been used in all four countries of our study. We have demonstrated that even if labour organizations act as a narrow interest group, they do not necessarily impede changes. Rather, they reorient the path to policy change, and may eventually become co-innovators in reforms whose benefits extend well beyond their traditional clienteles.

This does not mean, however, that unions are always able and willing to act for the general rather than a particularistic good. They rarely conform to the ideal of encompassing organizations that 'internalize the trade-offs inherent in the prospect of financing rising pension demands from the wages of younger cohorts of workers' (cf. Myles and Pierson 2001: 332). In fact, both in France and Italy, trade unions acted egotistically in defending their narrow self-interests and 'acquired rights' (both in terms of organization and membership) by shifting the burden of cutbacks on to non-represented groups (primarily the younger cohorts). They were quite ready to trade 'losses for someone else' with the defence of their own claims.

A third and final conclusion concerns the nature of concertation and policy trade-offs – the mechanism at the heart of our study. Regini (1997, 2000) argues that political exchange now consists primarily of a trade-off between cutbacks and institutional power, such as new opportunities for membership of a policy network, in a framework of *regulative* rather than *redistributive* politics. As we have shown above, the quest for institutional power has certainly been important for unions when pursuing their office-seeking objectives. Unions have also (especially in Italy prior to the Dini reform) played a critical role in designing



the plan for reform. But we also argue that reform packages have been based on redistributive bargains as well. In Italy, Germany and Spain, trade unions accepted cutbacks only if they were equitably introduced. Depending on the country, the trade-off was between cutbacks and improvements in inter- and intra-generational or functional (across social risks) equity. Moreover, cutbacks were introduced together with new and more favourable rules for supplementary schemes aimed at securing the average benefit level, represented by the combination of provisions from both public and private funds. At least in the Bismarckian welfare state, the logic of political exchange can still play a role in constructing both innovative and path-dependent redistributive reforms.

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### 3 Between conflict and consensus

#### The reform of Bismarckian pension regimes

*Martin Schludi*

##### Introduction

Pension reform has emerged as a central element in the restructuring of European welfare states in recent years. Starting in the mid-1970s, public pension systems became increasingly subject to powerful economic and fiscal strains. Moreover, the rising share of elderly persons will exert considerable pressure on public pension schemes in the long-term. Against that background, the focus of pension policy-makers moved (mostly irrespective of their party affiliation) increasingly towards a policy of retrenchment and cost containment. This motive became particularly evident in the 1990s, when virtually all advanced welfare states tried to dampen the growth of public pension expenditures (Hemerijck and Schludi 2000). This is especially true for countries with pension systems following the Bismarckian type (that is, contribution-financed social insurance operating on a pay-as-you-go (PAYG) basis) which appear to be particularly vulnerable to the pressures sketched above (Hinrichs 2000).

The first problem results from the mode of financing. Bismarckian pension systems provide relatively generous earnings-related benefits primarily financed out of social contributions. As a consequence, pension contribution rates are comparatively high by international standards, thereby boosting non-wage labour costs.

Second, public pensions (making up the bulk of total retirement income in the Bismarckian countries) are traditionally of the defined-benefit type. This construction has at least two problematic effects. On the one hand, defined-benefit arrangements often imply only a loose connection between contributions and benefits and thus tend to distort the supply for labour. On the other hand, defined-benefit regulations impose a quasi-contractual obligation for policy-makers to increase contribution rates, whenever pension outlays exceed revenues (Myles and Pierson 2001).

Third, in countries with pension arrangements of the Bismarckian type, the overall system of retirement income is predominantly based on the PAYG principle. In a PAYG-based system current contributors are obliged to pay the pensions for the contemporary generation of retirees. Whenever the numerical relationship between contributors and beneficiaries declines, this system will

come under fiscal strain. Thus, PAYG-financed systems are highly vulnerable to demographic ageing.

A fourth design feature that will put Bismarckian pension arrangements under increasing fiscal pressure results from the fact that benefit entitlements are typically derived from an employment relationship. This has an expansionary effect on pension spending in the context of rising labour force participation. In virtually all of the advanced welfare states, female participation rates have risen considerably over the last decades. In an earnings-related pension system this trend translates into a gradual augmentation of accrued benefit entitlements among female retirees and thus into higher pension costs in the future.

Finally, the pension systems in the Bismarckian countries are typically fragmented along occupational categories. More often than not, this is associated with marked differences in the generosity of benefits between the various schemes and thus with distributive disparities between different socioeconomic groups.

For all these reasons, cost containment pressures are generally greater in countries with Bismarckian-type pension arrangements than in countries that provide only flat-rate or even means-tested public pensions. However, while governments of countries with Bismarckian pension arrangements have acknowledged the necessity of drastically containing the expansion of pension costs, they also face substantial political impediments to implement such reforms. Despite an increasingly fierce climate of fiscal austerity, authors like Pierson (1994, 1997) have pointed to the remarkable resilience of welfare state arrangements, with pensions being the most resilient part of the welfare state. Moreover, in most Western countries Bismarckian pension systems display a high degree of 'maturation'. Consequently, the majority of contributors has already built up substantial benefit entitlements in the system and is therefore likely to oppose major cuts in the pension system. By the same token, governments that seek to scale down these pension entitlements face a substantial risk of electoral retribution (Myles and Pierson 2001). Thus, in the political struggle over the reform of Bismarckian pension systems, powerful pressures for cost containment collide with equally powerful forces defending existing institutional arrangements and entrenched benefit entitlements (Schludi 2005).

In the subsequent section I will give some empirical evidence about the extent to which countries with Bismarckian pension arrangements have been able to bring the imminent explosion of pension costs under control, revealing both instances of very successful cost containment reforms and instances of outright policy failure. Thereafter, I will present a theoretical framework that may be helpful to account for this remarkable empirical variance. I argue that governments have a fundamental interest in achieving the political support or at least the acquiescence of potential reform opponents, most notably of the parliamentary opposition and/or the trade unions. Subsequently, I analyse the conditions under which these actors are likely to cooperate with the government or not from a theoretical viewpoint. Finally, I will discuss how far empirical instances of pension reform can be located within this theoretical framework.

## The reform of Bismarckian pension systems: institutional resilience or successful adjustment?

Empirical evidence suggests that Bismarckian pension systems are less resistant to reform than frequently assumed. As far as the goal of long-term cost containment is concerned, countries with Bismarckian pension schemes have made substantial progress since the late 1980s. Figure 3.1(a) shows OECD projections carried out in the mid-1980s about the development of public pensions outlays under the assumption of an *unchanged* legal status quo for a number of countries with Bismarckian-type pension arrangements. Primarily as a consequence of demographic changes, pension spending levels were projected to reach more than 35 per cent of GDP in Italy, more than 30 per cent in Austria and Germany, about 27 per cent in France and about 18 per cent in Sweden until 2040. Although these figures need to be treated with some caution, they give some indication of the extent of policy changes that at the time were required in order to make the public pension systems in these countries more sustainable.

In the meantime, however, this picture has changed fundamentally. In all of these countries, pension liabilities were curtailed rather drastically in the late 1980s and 1990s. As a consequence of major pension reforms, pension spending levels are likely to remain far below 20 per cent of GDP in all EU countries throughout 2050 despite dramatically ageing populations (see Figure 3.1(b)).<sup>1</sup>

However, it would be a mistake to conclude that the adjustment of national pension systems to economic and demographic pressures flows smoothly. As a closer inspection of political decision-making processes in pension policy reveals, successful adjustment is anything but guaranteed. Within the cluster of

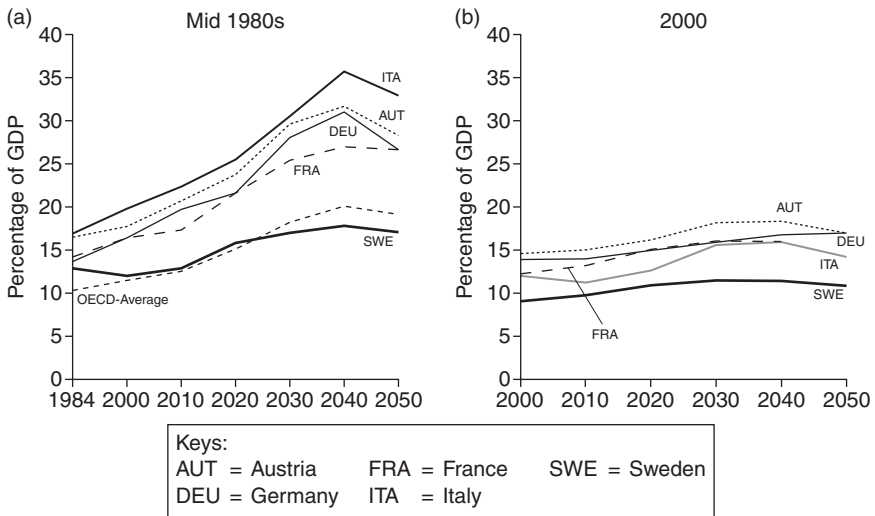


Figure 3.1 Pension expenditure projections (as a percentage of GDP) (source: OECD (1988) and Economic Policy Committee (2001)).

countries with Bismarckian pension arrangements we find many instances of both (relatively) successful and (largely or even completely) failed reform initiatives (see Table 3.1). Among the failed reform initiatives we can identify instances where governments withdrew planned pension cuts because they proved unable to organize a parliamentary majority (such as in Austria in 1994) or because they encountered massive public resistance in the form of mass demonstrations and prolonged industrial actions organized by the trade unions (Italy 1994; France 1995). Other reforms were rescinded when a new government had come to power (such as a major pension reform in Germany, which had been adopted in 1997 by the bourgeois Kohl government and was reversed after a red-green government had assumed office in 1998). Moreover, we can discern periods of 'non-decision', in which governments abstained from major pension reforms, although they did not deny the necessity of pension cuts. The incumbency of the French left-wing coalition government under Lionel Jospin (between 1997 and 2002) may serve as a case in point. In still other cases, governments were forced to water down their original reform plans beyond recognition and only achieved very incremental adjustments (such as the 1997 pension reform in Austria). Other reform initiatives proved to be relatively successful and entailed far-reaching cuts in the pension system (Austria 2003; Germany 1989; Sweden 1994; Italy 1995). This suggests that the conditions for successful adjustment in pension policy vary considerably *across* but also *within* countries.

Which factors account for this remarkable variation in reform outcomes? It appears that, more often than not, pension reform initiatives failed if governments lacked the political support of both the parliamentary opposition and the trade unions. By contrast, governments were more successful when they succeeded in bringing at least one of these actors 'on board'.

### ***The political advantages of concerted pension reform***

Despite the general unpopularity of pension cuts, governments do not necessarily become the subject of electoral retribution when they opt for pension retrenchment. This is because voters will only react to government actions regarding pension policy if political actors outside the government successfully mobilize the public against it. In line with Scharpf (1997), this process can be seen as a sequential game between three players (see Figure 3.2). The government moves first and has to decide whether it launches a major legislative initiative in pension policy or not. If significant cost containment measures are not taken, the government will often be forced to increase contributions or taxes in order to avoid financial deficits in the pension system. Given the government's choices, the opposition must then decide whether to ignore the issue, support the proposal, or use its limited resources to oppose the initiative and mobilize voters on a large scale.<sup>2</sup> In the former case, we can assume that voters will largely ignore the issue. In the latter case, swing voters may either ignore the issue or agree with opposition criticism and vote against the government in the next election. Given the extraordinary significance of pension policy for the incomes of

Table 3.1 Political support of pension reforms and passage of legislation

<i>Country/year</i>	<i>Support by opposition parties?</i>	<i>Support by trade unions?</i>	<i>Reform adopted?</i>
Sweden 1994	Support by SAP; Communists and New Democracy vote against	Unions largely support the reform	Yes
Italy 1992	No	Acquiescence	Yes
Italy 1994	No	Unions fiercely opposed, large-scale protests	No
Italy 1995	Part of opposition votes against, other part abstains from voting.	Reform largely drafted and actively supported by all major trade unions	Yes
Italy 1997	Bourgeois opposition votes against. After initial refusal, Communists vote in favour	Yes	Yes
Germany 1989	Support by SPD; Greens vote against	Unions largely support reform	Yes
Germany 1997	No. SPD makes pension cuts a major electoral issue	No	Reform later suspended by red-green government
Germany 2001	No	After massive protests and far-reaching concessions by government, unions approve final reform package	Yes
Austria 1993	No (but government is formed by a 'grand coalition' of SPÖ/ÖVP)	Reform largely drafted and actively supported by the social partners	Yes
Austria 1997	No (but government is formed by a 'grand coalition' of SPÖ/ÖVP)	After massive protests and far-reaching concessions by government, unions approve final reform package.	Yes
Austria 2000	No	No	Yes
Austria 2003	No	No. Unions organise country-wide 'defense strikes'	Yes
France 1993	No	No, but protests remain limited	Yes
France 1995	No	No. Unions organise large-scale strikes	No
France 2003	No	CFDT strikes formal agreement with government	Yes
		CGT and FO continue to mobilise against reform	

Source: based on Schludi (2005).

Notes

CFDT = Confédération Française Démocratique des Travailleurs

CGT = Confédération Générale du Travail

FO = Force Ouvrière

ÖVP = Österreichische Volkspartei

SAP = Sozialdemokratische Arbeiterpartei

SPD = Sozialdemokratische Partei Deutschlands

SPÖ = Sozialdemokratische Partei Österreichs

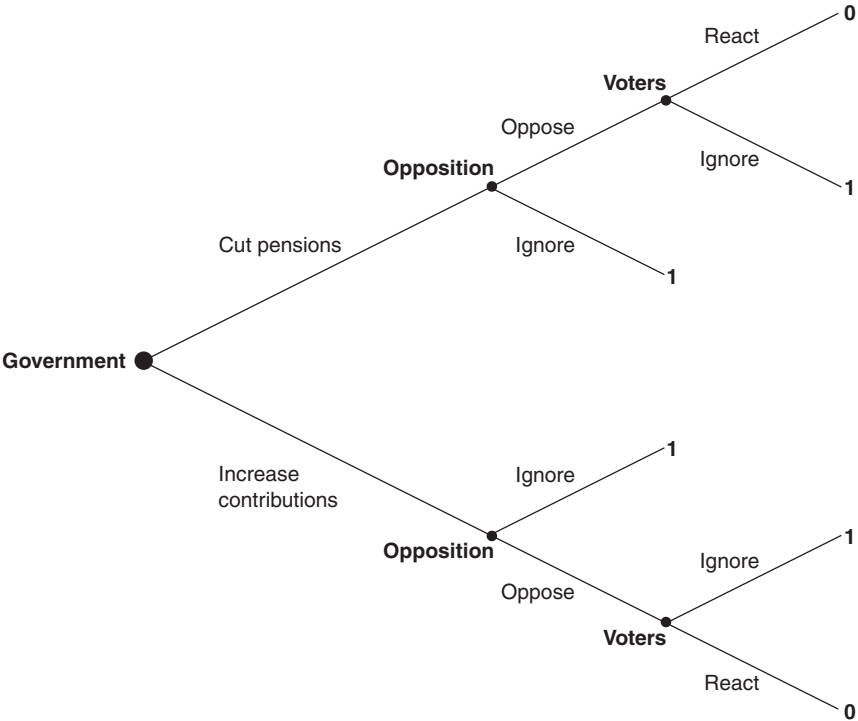


Figure 3.2 Sequential game between government, opposition and voters (source: based on Schludi (2005)).

large elements of the population, there is a great chance that voters will respond to the issue of pension reform. Hence, faced with the threat of electoral retribution, governments typically have a powerful incentive to obtain the at least (tacit) agreement of those actors who are most capable of mobilizing large sections of the electorate against its pension reform plans.

Typically, this pattern may apply not only to the parliamentary opposition but also to the trade unions. At least in Continental Europe, trade unions still play a crucial role as defenders of earnings-based social insurance schemes and may have the capacity to mobilize their members and large sections of the public against adverse welfare reforms. Conversely, unions' approval or at least their acquiescence is likely to reduce the general political resistance against unpopular pension reforms (Anderson and Meyer 2003; Palier 2000).

However, governments may have additional reasons to seek consensus with these actors in pension policy. First, both the opposition and the trade unions may – at least indirectly – occupy veto positions in the decision-making process allowing them to block governmental pension reform initiatives. Second, policy-oriented governments must have an interest in sustaining the durability of



enacted reforms by assuring that these are not overturned after the next election.<sup>3</sup> Third, predictability and reliability of pension policy (as opposed to frequent and unexpected ad hoc interventions by the government) constitutes its own value. By their very nature, pension reforms imply more or less profound changes in the retirement income packages, particularly for future pensioners. As current contributors have to adjust their employment biographies and their savings behaviour long in advance, they have a genuine interest in the long-term predictability of pension policy and thus in a broad political and societal consensus on pension reform. Finally, by striking agreements with external political actors, the government may effectively neutralize internal reform opponents. For instance, a broad cross-party agreement will generate broad parliamentary majorities and thereby disable the potential veto power of reform adversaries within the government factions themselves.

For these reasons, it should not come as a surprise that successfully implemented pension reforms are mostly concerted reforms (Pierson 1998; Baccaro 2000; Hinrichs 2000; Council of the European Union 2001; Myles and Pierson 2001). By the same token, the efforts of governments to form a broad pension consensus typically go above and beyond the search for a simple parliamentary majority (Hinrichs 2000). If governments attempt to impose pension reforms unilaterally they run the risk of being voted out of office or being forced to withdraw their reform plans.

Hence, we need to focus on two crucial arenas of pension politics: the partisan arena as a potential platform for a pension consensus between government and opposition, and the corporatist arena as a potential platform for a pension consensus between government and trade unions. Basically, each arena may provide for a stable political support base for pension reform. With a broad partisan consensus, pension reform may become politically feasible even if unions oppose the reform. First, a consensus backed by the major political parties provides a stable parliamentary majority, which trade unions could not effectively oppose. By contrast, if the ruling parties can only manage a slim majority and do not win the parliamentary support of the opposition, even a comparatively small trade union opposition along with other internal opponents may have enough power to stop the government. Second, a broad cross-party agreement would deprive unions of the ability to exploit the electoral division between the government and the opposition.

Conversely, the parliamentary opposition will face greater difficulties in blaming the government for unpopular pension cuts, if the reform is supported by the trade unions which enjoy great credibility as defenders of the welfare state. Moreover, support by the unions would make it easier especially for a left-wing government to organize a consensus within its own ranks. To be sure, in cases where the opposition party has institutional veto power (for example, by controlling a second chamber whose agreement is necessary to adopt pension legislation) trade unions' support will not be enough to overcome the opposition.

It needs to be emphasized that the conceptual framework sketched above is specifically geared towards the political logic of pension retrenchment and is not

applicable to every public policy. Most importantly, unpopular policies like pension retrenchment operate in a different way than popular ones such as the introduction of new social benefits. While the expansion of benefits can be interpreted as a strategy of credit-claiming on the part of the government, the politics of retrenchment is typically a political game aimed at blame-avoidance (Pierson 1994). In contrast to an expansion of pension benefits the retrenchment of pension entitlements is typically associated with substantial political (most notably electoral) costs. Hence, it is only highly unpopular policies (such as large-scale pension cuts) where governments must have a strong self-interest in sharing the blame with other political actors.

### *Pension politics in the partisan arena*

As Pierson (1998) has pointed out, we still know relatively little about the circumstances that facilitate or impede the negotiation of substantial adjustments. Therefore, we need to ascertain more systematically the positive and negative incentives for both trade unions and opposition parties to arrive at a consensus with the government. I will deal with this question in the following sections.

First, the opposition not only has a substantive interest in pursuing its own policy goals through favourable compromises but also a competitive interest in defeating government initiatives in order to undermine the government's political reputation (Scharpf 2000). Opposition parties may therefore be tempted to denounce the government for 'unfair' pension cuts or 'breached election promises' in order to improve their own electoral standing, even if they do not deviate very much from the government's position in substantive terms (Kitschelt 2001). However, opposition parties have to mediate between their substantive policy interests on the one hand, and their interest to maximize their election chances on the other hand. In principle, the opposition has three strategic options in its reactions to the government's pension reform initiative:

- 1 It may try to negotiate a pension compromise with the government in order to move the reform output as close to its ideal point as possible. In this case, however, the opposition would forego the opportunity to exploit the pension issue in the electoral arena (as it can no longer attack the government on this issue).
- 2 Alternatively, the opposition may refuse its support though without promising to reverse the cutbacks after a change of government. In this case, the opposition would profit from the potential long-term economic benefits resulting from reform (such as higher economic growth and higher employment). On the other hand, it would be unable to influence the content of the reform and foregoes the possibility of fully exploiting the potential electoral gains that may accrue by the promise of a reversal of the government's benefit cuts. To be sure, this strategy would only be available if the opposition has no veto power in the decision-making process.
- 3 Finally, an opposition party may conduct a large-scale election campaign

against a government's pension reform including the promise to reverse the cutbacks after a change of government. In the short term, this strategy may be the most promising for those seeking a change in government. However, if it does not remain true to its election promise after taking office, it will seriously damage its credibility in the eyes of the electorate. If it sticks to its promise by reversing the preceding government's cutbacks, it still has to resolve the issue of rising pension costs and may then find it even more difficult to legitimize pension cuts.

How does an opposition party solve this strategic dilemma? Table 3.2, in a highly stylized manner, depicts the constellations under which an opposition party would likely cooperate with the government (see Schludi 2005).

As I argue, the opposition's willingness to enter into a pension consensus with the government depends on the interaction of two factors, denoted as 'policy distance' and 'positional conflict'. For heuristic reasons, I distinguish three possible gradations of policy distance:

- We may define the policy distance between government and opposition as *large*, if these actors position themselves at opposite sides of the status quo (based on the assumption of a continuum stretching from a massive expansion of pension benefits on the one hand to radical retrenchment of the pension system on the other).
- The policy distance between two actors is denoted as *significant*, if the respective ideal points are at some distance from one another, but are still located on the same side of the status quo.
- The policy distance is defined as *small*, if two actors occupy relatively similar positions on the continuum.

To a certain extent, the government is capable of reducing the policy distance between itself and another actor. It should be kept in mind that pension policy covers several dimensions going beyond the issue of mere cost containment. While cost containment may be the primary concern for governments, pension

Table 3.2 Likelihood of a partisan consensus on pension reform

		<i>Policy distance between parties</i>		
		<i>Large</i>	<i>Significant</i>	<i>Small</i>
<i>Positional conflict</i>	High	—	—	—
	Medium	—	(+)	+
	Low	+/-	+	+

Source: based on Schludi (2005).

Notes

- + Emergence of consensus likely
- Emergence of consensus unlikely

reforms are often a package comprising a broad array of different elements. These may for instance include measures that change the coverage or the financing structure of a pension system or establish new fully funded forms of old-age provision. Thus, pension reform is typically located in a multi-dimensional policy space. This again may allow the government to design pension reform packages that include targeted concessions or side-payments to potential reform opponents (Bonoli 2000). Moreover, the government may combine pension reform with reform measures in other policy areas where the distance to other actors may be much lower. Thus, the skilful design of reform packages may help to reduce the overall policy distance between two actors and therefore improve the basis for a mutual agreement over pension reform.

With the dimension of 'positional conflict' I try to measure the degree to which an opposition party is able and willing to improve its strategic position at the expense of the governing parties. Analytically, I distinguish three levels of positional conflict:

- As a rule, the degree of positional conflict between government and opposition will be quite high in a party system where political majorities are narrow and where elections typically have a strong impact on the composition of the government.<sup>4</sup> This may be reinforced when elections are frequent or when a majority-based electoral system exists.
- However, even in a highly competitive party system, situational and policy-specific factors may (temporarily) lead to a reduced level of positional conflict on certain issues. For instance, if opinion polls indicate that an opposition party is going to return to power after the elections, its incentives to exploit unpopular issues such as pension reform in the electoral arena may be substantially lowered. By the same token, the willingness of an opposition party to co-operate with the government might be greater if there are no major elections in the near future. With respect to social policy issues, positional conflict is moderated if an opposition party has great difficulties in presenting itself as a credible defender of the welfare state. A market-liberal opposition party, for instance, will have a hard time presenting itself as a reasonable alternative to voters dissatisfied with welfare cut-backs implemented by a left-wing government.
- Finally, positional conflict can be characterized as low, if government and opposition parties are competing for votes but not for office. Under certain conditions, an opposition party might even have an interest in keeping rather than replacing an existing government constellation. For instance, it cannot be in a communist opposition party's interest to have a social democratic government replaced by a bourgeois one. Alternatively, an opposition party may cooperate with the government to present itself as a potential coalition partner of the ruling party.

In practice, to be sure, both 'policy distance' and 'positional conflict' are continuous rather than discrete variables. Moreover, both concepts may combine dif-

ferent dimensions or aspects. For instance, two political parties may agree on the volume of pension retrenchment that is deemed necessary but may differ substantially over the concrete *design* of these cuts. Hence, there are no easily measurable indicators to assign exactly the distance between political parties in pension policy. This is even more true for the variable 'positional conflict'. As suggested above, the intensity of positional conflict between a government and an opposition party depends on a broad range of both situational and structural factors and thus can only be defined at a rather abstract level. Nevertheless, while they defy an exact measurement, both variables are useful to grasp the logic of pension politics in the partisan arena.

I argue that the degree of an opposition party's cooperation is the combined function of its policy distance to and its positional conflict with the parties in government. The opposition is unlikely to cooperate with the government if both its policy distance to and the degree of positional conflict with the government is high. In this case a cross-party pension consensus will not emerge. Conversely, a constellation of 'low positional conflict' and 'small policy distance' will be highly conducive to a pension consensus.

However, the opposition is faced with a strategic dilemma if policy interests and competitive incentives operate in opposite directions. For instance, a small distance between the policy positions would allow for a cross-party consensus, although this could be countervailed by strong competitive incentives for the opposition not to cooperate. To the extent that disagreement with the government strengthens not only its electoral prospects but also its chance to replace the government, an opposition party would probably not support a government's pension reform. Thus, in a situation of strong positional conflict, I predict that an opposition party will thwart a pension consensus with the government irrespective of its material policy goals. Hence, even a small distance in pension policy may not suffice to create a cross-party pension consensus in the context of fierce party competition.

Conversely, a low level of positional conflict between government and opposition clearly facilitates negotiated adjustment. In this constellation, strategic considerations do not only enable but *reinforce* the search for consensual policies. For instance, an opposition party may try to demonstrate its cooperativeness by supporting the government's enactment of unpopular welfare reform. In doing so, it positions itself as a potential coalition partner.<sup>5</sup> Nevertheless, even in the context of low positional conflict between the government and an opposition party, we cannot generally assume that the latter will be prepared to support government policies that are diametrically opposed to its own policy interests, as this may drastically harm its chances to maximize votes.

Finally, in configurations of medium-level positional conflicts, strategic considerations enable a relatively policy-oriented bargaining process. Here the likelihood of a pension consensus is largely dependent on the policy distance between government and opposition. I predict that a policy-oriented opposition party would not join forces with the government, if the policy distance between the two is large. If it is confronted with a policy outcome that is (from its own

perspective) inferior to the status quo, an opposition party will either try to block the reform or try to reverse it after the government constellation has changed. If a medium level of positional conflict is not combined with a large policy distance, a negotiated solution is basically within reach. That is because this constellation allows for policy outcomes that are superior to the status quo for both sides, while the absence of strong competitive incentives facilitates policy-oriented bargaining.

### ***Pension politics in the corporatist arena***

As suggested above, a consensus between government and trade unions will in many cases create a stable political support base for pension reform even if the reform is not backed by the parliamentary opposition. Unlike the opposition parties, trade unions have basically no competitive incentives vis-à-vis the government. Their primary interest revolves around substantive policy solutions not electoral competition (Scharpf 2000).

Although this constellation may favour a pension consensus between these actors, the pension policy goals of government and trade unions often diverge considerably. In principle, this is also true for left-wing governments. Under conditions of fiscal austerity, unions can no longer count on the uncompromising political support of labour governments (Ney 2001). Trade unions, by contrast, tend to adopt a pension policy position that is much closer to the status quo. In particular, trade unions often resist major pension cuts even if this means higher contribution rates. Given the common ideological roots of trade unions and social democracy, the increasing divergence of their pension policy positions is remarkable. We can identify a number of reasons which may help account for this phenomenon.

First, the membership of most trade unions is characterized by a relatively pronounced seniority bias. As a consequence, union leaders often end up defending the interests of elderly workers. In principle, unions face a trade-off between the interests of contributors and beneficiaries when they develop their own approach to pension reform. However, this trade-off is moderated by the fact, that current contributors are also future pensioners. With increasing age, public pension insurance contributors become increasingly less likely to accept the scaling down of their own pension claims. Hence, it is mostly elderly workers who resist pension cuts. At the same time, it is precisely this age group that is the most influential among trade unions' rank and file (Brugiavini *et al.* 2001).<sup>6</sup> What is more, in some countries pensioners account for a sizeable share of union membership. In Italy, for instance, approximately half of the union members are pensioners (Fargion 2000). Thus, the trade unions' rank and file typically displays a stronger age-bias than the general electorate.

Second, trade unions by their very nature represent the interest of wage earners (or in the case of a specific union, only of a certain segment of wage earners) rather than the general society as a whole. At the same time, they tend to regard contributory pension entitlements as a form of 'deferred wage'. Hence,

from the union's point of view, pension politics primarily reflects a distributive conflict between capital and labour rather than between older and younger generations. This is also why trade unions strongly encourage the participation of employers in the financing of old age provisions. Trade unions also typically call for stronger state involvement in the financing of public pensions, which would mitigate the potential conflict of goals between contributors and pensioners. By contrast, even left-wing governments cannot confine themselves to representing the 'narrow' interests of wage earners and pensioners. Political parties must also pay attention to the interests of other social groups like the unemployed, students, single mothers and self-employed people. To the extent that an increasing share of public resources is devoted to the payment of pensions, tight budgetary constraints forces governments to cut expenditures in other areas of public services such as family benefits, education and public infrastructure. This again would seriously violate the interests of groups not represented by trade unions but which may nevertheless be crucial for the electoral prospects of political parties.

Third, trade unions also tend to defend existing pension arrangements as an instrument that offers relatively attractive pre-retirement options to older workers at the expense of the general tax-paying population. The accessibility of this 'exit option' also increases unions' bargaining power vis-à-vis the employers. In other words, the access to generous soft landing options via the public pension system will reduce the pressure on unions to moderate their wage demands (Brugiavini *et al.* 2001). Governments have instead become increasingly aware of the fact that continuing generous pre-retirement options will mean unbearable burdens on the public budget.

This does not mean that trade unions will reject cuts in the pension system as a matter of principle as they also must have an interest in the financial sustainability of the pension system. Nevertheless, for the reasons sketched above governments are likely to favour larger and quicker pension cuts than trade unions, while the latter are interested in moderating or even impeding such reform efforts. In principle, trade unions have at least three strategies at their disposal to achieve this goal (Anderson and Meyer 2003). First, they may try to change the reform outcome by *bargaining* to win a package deal with the government. In exchange for their political support of the reform package, they may obtain significant government concessions or side-payments. Second, unions may try to influence reform content by *lobbying*, mainly through party channels. If unions manage to organize a critical mass of supporters within political parties (and especially in parliament) they may have the power to block the reforms they do not like. Third, trade unions may try to *mobilize* their members or even the general public against the reforms. This may take the form of public declarations, demonstrations, or even strikes. This strategy may increase the political (especially the electoral) costs of reform to the government.

These strategies are not necessarily mutually exclusive. Quite the contrary, union success may occur when they combine these strategies. For instance, the unions' bargaining power may increase when they exert additional pressure on



the government by intensifying their lobbying activities or by mobilizing (or at least threatening to mobilize) protests against the government's plans in the public arena. Nevertheless, the relative significance of these strategies may differ considerably. Most importantly, however, the final outcomes of these interactive processes may be radically different. Unions and the government could arrive at a specific agreement regarding reform content. Another possibility is that they fail to agree on pension policy resulting in a head-to-head confrontation, at the end of which one side must give in. Moreover, both an agreement and a non-agreement may offer a broad range of possible outcomes regarding reform content depending on how far the government is willing to – or forced to – accommodate union demands.

Despite differences in pension policy positions between governments and trade unions, the latter are more likely to prefer negotiated reform (which may offer them a voice in its implementation) over a reform that is unilaterally imposed by the government (or by a 'grand coalition' of government and opposition parties). The government typically prefers a negotiated reform, in which trade unions offer a 'green light' to unpopular welfare cutbacks. However, the government has to balance its desire to obtain union consent with its desire to implement real changes. If union consensus is its primary goal (rather than reform implementation), it ends up handing unions a *de facto* veto power (Wijnbergen 2000).

Under what conditions will both actors agree on pension reform and where will the final agreement be situated? Figure 3.3 depicts, in a highly stylized manner, the possible bargaining constellations between the government and the unions, assuming that the pension policy preferences of the relevant actors can be depicted on a one-dimensional policy space (indicating the degree to which a reduction in pension spending is seen as necessary).

The bottom line is that three factors determine the policy outcome:

- First, the location of the government's preferred policy outcome, that is, its ideal point in a given policy space.
- Second, the location of trade unions' ideal point. As suggested above, there is reason to assume that unions' ideal point in pension policy will be significantly to the left of the government's ideal point

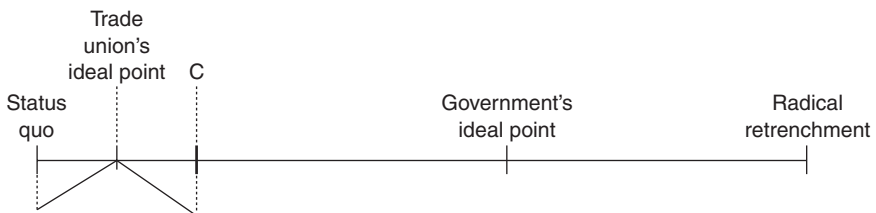


Figure 3.3 Bargaining constellation between government and trade unions (source: based on Schludi (2005)).



- Third, the location of the non-agreement point, that is, the location of the policy outcome that will result when no agreement is achieved. Non-agreement between the two means maintenance of the status quo if the government is either unwilling or incapable of imposing the reform on the trade unions. Conversely, non-agreement may also lead to a policy outcome that is identical to (or at least similar to) the government's position, if the government is both willing and capable of imposing this reform even without unions' approval.

Thus, in order to assess the final position of the policy outcome we have to proceed in two stages. First, we need to localize the ideal points of the government and of the trade unions. Once their ideal points have been established, we must assess the position of the non-agreement point.

The government's ideal point in pension policy is likely to reflect the strength of cost containment pressures rather than its general political orientation. The stronger these pressures are and the more vulnerable a pension system is to these pressures, the more necessary cost containment reforms become and the more the government's ideal point will diverge from the status quo.

The intensity of adaptational pressures may also have an impact on the pension policy outcome preferred by the trade unions. The reason is that trade unions must also have a fundamental interest in the long-term sustainability of public pension arrangements. However, specific trade union features such as their traditional ideological orientation, the share of elderly workers and pensioners in the rank and file or the degree of their organizational fragmentation may also have a considerable impact on their pension policy preferences. Thus, from a pure theoretical perspective, we cannot derive beforehand whether unions' ideal point in pension policy outcome will be to the left or to the right of the status quo.

Finally, the policy outcome resulting from government and trade union negotiations will depend on the location of the non-agreement point. Unions may be able to block or at least mitigate pension reform bills via lobbying efforts, especially if the government is institutionally weak and ideologically fragmented and also if trade union functionaries and their allies control important executive and legislative party offices (Kitschelt 1994). Alternatively, they may be able to mobilize large-scale protests among their members or even among a large section of the general public against the government's reform plans.

In a constellation where they have an actual chance to defend the status quo, unions will not accept an outcome that is (from their point of view) inferior to the status quo. Given its agenda-setting power, the government, in this case, proposes a reform located at C (see Figure 3.3). C is to the right of the unions' ideal point and equidistant from the unions' ideal point and that of the status quo. Provided that the unions are capable of impeding the reform, unions will oppose any outcome to the right of C. Thus, within this power constellation the location of the final bargaining outcome can be directly derived from the unions' ideal point and its distance from the status quo. This also means that even a 'weak'

government can achieve far greater pension cuts if a trade union is relatively reform-oriented and acknowledges the need for cost containment measures. Conversely, if unions' ideal point is identical with or even to the left of the status quo a 'weak' government will be incapable of shifting the status quo to right, in other words, there will be no significant adjustment at all. Under these conditions unions will have only little interest to negotiate with the government. Instead, they are likely to resort to a strategy of counter-mobilization against governmental pension retrenchment efforts. Alternatively, they may try to block the reform in the legislative process via lobbying.

The bargaining constellation looks different, if the non-agreement point is identical with the government's ideal point. Here we assume that an institutionally strong government with a low degree of electoral vulnerability can convincingly impose painful pension cuts despite union resistance. This means that a policy-oriented union is always prepared to accept an outcome inferior to the status quo (and thus to the right of C) as long as the government is willing to make at least some concessions. In doing so, the unions may avoid an even worse outcome if the government had acted unilaterally. In this situation unions will have a greater chance to influence the 'agreement point' to their favour if they enter into negotiations with the government (rather than mobilizing their members against the governmental pension plans).

### *The scope of concerted pension reforms: some empirical evidence*

As mentioned above, there is strong empirical evidence that pension reform initiatives that are opposed by the trade unions and the parliamentary opposition alike run a high risk of political failure. Unilateral pension reforms that were successfully implemented appear to be the exception rather than the rule. Among these exceptions we find for instance the pension reforms adopted by the bourgeois government in Austria in 2000 and 2003. In this case, unilateral reform was facilitated by the combination of various factors. Most importantly, the government had a rather solid parliamentary majority and the trade unions had only very limited institutional influence within the governing parties. Moreover, since these reforms were adopted at the beginning of the legislative term, the danger of electoral retribution was significantly moderated. In addition, Austrian trade unions (other than their French or Italian counterparts) display only a limited mobilizing capacity in terms of mass demonstrations and industrial actions.

Despite the frequent failure of unilateral pension reform initiatives it would be mistaken to assume that the successful forging of a pension consensus frequently entailed the implementation of far-reaching adjustments. Instead, within the cluster of Bismarckian countries we find instances of concerted pension reform where the government proved able to implement very substantial changes as well as instances of concerted reform where governments were forced to water down their reform plans drastically and only yielded very incremental savings.

In cases where a pension reform was primarily based on a broad cross-party agreement, the enacted adjustments were typically greater and faster than where the pension reform was hammered out between the government and the trade unions. The German 1992 pension reform and the recent pension reform in Sweden are cases in point. There, situational factors reduced the degree of positional conflict and allowed for a relatively policy-oriented bargaining process between the political parties. In both countries the (then social democratic) opposition expected to return to power and thus deemed it unnecessary to exploit the pension issue in the electoral arena. Interestingly, the social democratic party leaders in both countries were willing to strike a pension deal with the bourgeois government although they were forced to make a number of substantial concessions. This suggests that a pension consensus in the partisan arena requires a reduced level of positional conflict between government and opposition but not necessarily an approximate identity of their policy positions. Both reforms implied comparatively large reductions of pension costs in the medium and long run and – in the Swedish case – comprehensive structural changes. In both cases, the trade unions exerted some influence on the reform process through party channels but they were not directly represented at the bargaining table. Thus, the main features of both reforms were primarily developed through cross-party negotiations rather than through negotiations between government and trade unions. Hence, the final result largely reflected the policy positions of the major political parties, which advocated more far-reaching changes to the status quo than the trade unions.

At the same time, however, empirical instances of pension reform based on a broad cross-party consensus appear to be exceptions to the rule. More often than not opposition parties could not resist the temptation to exploit the pension issue in the electoral arena even when their material policy goals did not deviate radically from the government's policy positions. The German pension reform of 2001 is a case in point. Here, the actual policy distance between the centre-left Schröder government and the Christian-democratic opposition was apparently rather small. Basically, both sides did not differ fundamentally over the necessary volume of pension cuts as well as over the creation of a new fully funded pension pillar. Moreover, the government made comprehensive concessions to basically all of the Christian democrats' criticisms. Nevertheless, the Christian democrats continued to reject a common pension reform agreement. Instead, they sought to exploit the pension issue in the electoral arena, in particular with a view to a number of imminent elections at the *Länder* level. This example is in line with my theoretical expectation that even a low distance between pension policy positions is not a sufficient condition for the emergence of a cross-party consensus if the intensity of positional conflict between government and opposition is high (Schludi 2005).

Empirically, we find much fewer instances of low positional conflict between government and opposition as the latter typically has a strong self-interest to replace the parties in government. However, as suggested in the theoretical framework, there may be exceptions to the rule. For instance, political

competition between an opposition party at the far left and a centre-left government may be drastically moderated if the centre-left government runs the risk of being replaced by a bourgeois one. The pension cuts implemented by the Prodi government in 1997 are a case in point. The Communist Reconstruction Party RC (*Rifondazione Comunista*), hitherto a backer but not a member of the left-centre minority government, announced that it was blocking the reform in parliament. As the bourgeois opposition had already announced it was voting against the bill, the government was forced to win the support of the communists. Initially the RC rejected the cuts, which again precipitated a veritable government crisis. However, after the Prodi government offered more modest pension cuts combined with important concessions in other policy areas (such as the introduction of the 35-hour work week), the Italian communists were prepared to support the cutbacks. To a great extent, this was attributed to the notion that the communists would have caused the fall of a leftist government if they had continued to oppose the reform (Schludi 2005).

While there are only comparatively few pension reforms based on a broad cross-party consensus, we find more instances of pension reforms based on concertation between the government and the trade unions. Despite substantial disagreements over the scope of pension cuts, in many cases government and trade unions finally settled their conflicts and arrived at an at least implicit agreement. This finding is in line with my above-sketched theoretical argument that for the trade unions (other than for the parliamentary opposition) conflict with the government is no end in itself. As suggested above, scope and content of these agreements differ widely depending on the policy distance and on the power constellation between these two actors. The Austrian 1997 pension reform and the 1995 pension reform in Italy may serve as an empirical illustration. In both cases, reform pressures were extraordinarily high and in both cases the governments were keen to reduce future pension outlays substantially. Moreover, in both cases the final reform package was supported by the trade unions. However, while the 1997 pension reform in Austria reduced the growth of public pension expenditures until 2030 by only 0.7 per cent of GDP, the 1995 pension reform in Italy implied a much stronger long-term savings effect, corresponding to about 3 per cent of GDP. Moreover, while the Austrian pension reform of 1997 only included very incremental changes to the pension formula, the Italian reform resulted in a complete changeover from a defined-benefit to a defined-contribution system (Schludi 2005).

How can we account for this remarkable difference in the scope of pension reform? In the Austrian case, the meagre reform outcome appears to be the combined effect of unions' institutional veto power within the internally estranged SPÖ/ÖVP government and their unwillingness to accept more than marginal cost containment measures. Initially, the government tried to enact substantial benefit cuts without first consulting the social partners. However, in the face of fierce opposition by the trade unions (who saw little need for pension cuts shortly after the adoption of the 1996 savings package which had entailed a number of significant and short-term effective cost containment measures), the

government finally opted for an inclusion of the social partners in the reform process. Due to the strong weight of trade unionists within the social democratic party, those politicians opposing a 'pension reform without the social partners' gained the upper hand in the government camp (Tálos and Kittel 1999). Moreover, the trade unionists within parliament threatened to launch a vote of no confidence against the socialist chancellor if the government refused to abandon its reform plans. In a last-minute deal, the social partners and the government agreed on a drastically watered-down version of the previous reform plan.

In Italy, the political process leading to the adoption of the 1995 pension reform took a radically different course. In 1994, the Berlusconi government had withdrawn its pension reform plans in the face of large demonstrations and industrial actions organized by the trade unions. At least, it had arrived to an agreement with the trade unions that a comprehensive pension reform should be negotiated between the government and the social partners in the next year. These negotiations took place under a new caretaker government led by the former finance minister Lamberto Dini. Thus, from the outset the Italian unions were given a strong say in the implementation of the 1995 pension reform. At the same time, Italian trade unions clearly acknowledged the necessity of fundamental changes in the Italian pension system. On the one hand, they were well aware of the distributional flaws and the financial unsustainability of the old pension regime. On the other hand, they had come to realize that retention of the status quo in pension policy would also jeopardize Italy's membership in the European Monetary Union (EMU). Finally, they feared that a failure of the Dini reform might prompt a subsequent, potentially more labour-hostile government to impose even harsher reforms (as Berlusconi attempted in 1994). Against this background, Italian trade unions were (in contrast to their Austrian counterparts) prepared to support a switch from a defined-benefit to a defined-contribution system. The Dini government, in turn (and in contrast to its predecessor), accepted a very long transition period for the phasing-in of the new pension system. In sum, a strong case can be made that unions' support was crucial in sustaining the political feasibility of the reform package (Schludi 2005).

The Italian case also illustrates that trade unions should not generally be seen as unconditional defenders of the status quo in pension policy. Under certain conditions, they may accept pension cuts as a means to restore the long-term financial viability of the pension system and to achieve a more equitable pension system.

Moreover, unions are likely to accept pension cuts more easily if the government is able to offer attractive compensation payments. Most importantly, there is strong empirical evidence that unions have developed a strong interest in measures that ensure and broaden the revenue bases of contribution-based pension schemes (such as an extension of the scope of contributors and a shift in the financing of non-contributory benefits from social contributions to taxes). In many cases, this has allowed pension policy-makers in the Bismarckian countries to devise reform packages where unions accepted moderate pension cuts in return for measures that prevent the financial erosion of the social insurance system and shift part of the pension costs from wage earners to tax payers.

Sometimes these reform packages also contained elements that were in the organizational self-interests of trade unions. In France, the Balladur government in 1993 combined pension cuts in the private sector with a clearer separation of contributory and non-contributory benefits by funding the latter out of the state budget. In doing so, the government implicitly acknowledged the social partners as the legitimate actors for the management of the contributory elements of the insurance schemes. In Germany, the pension reform adopted in 2001 established the precedent of collective agreements in the area of fully funded old age provisions and thereby strengthened the co-determination of unions with respect to occupational pensions. By contrast, unions vociferously attacked any reform attempts that threatened to undermine their organizational or institutional power bases. In 1995, the French Juppé government, for instance, sought not only cuts in public sector pensions but also intended to extend its grip on social security at the expense of trade unions by introducing a parliamentary vote on the social security budget. This measure clearly contributed to the bitter resistance of the French labour movement and thus to the final failure of pension reform.

## **Conclusion**

As a closer inspection of pension politics in the Bismarckian countries reveals we cannot simply derive pension policy outcomes from the mere presence of 'functional imperatives' or from a government's policy preferences. Instead we need to pay much more attention to the specific actor constellation underlying the politics of pension reform. This is especially true if we try to explain the success or failure of governmental pension reform initiatives. Based on the empirical analysis of pension politics in Bismarckian countries we may summarize the key findings as follows (Schludi 2005).

Neither the retention of the status quo nor a radical dismantling of existing pension entitlements appears to be a realistic political option for contemporary pension policy-makers in the Bismarckian countries. By the same token, the pension policy positions of both social democratic and bourgeois parties have increasingly converged in recent years. It is the intensity of cost containment pressures rather than their partisan complexion that prompts governments to put pension reform on the political agenda.

Pension reform under the conditions of fiscal austerity and demographic ageing is inevitably unpopular. In order to reduce the associated electoral risks governments seek to obtain the political support (or at least the acquiescence) of those actors most capable of mobilizing large groups of voters against pension cutbacks most notably the parliamentary opposition and the trade unions. There is strong empirical evidence that the political feasibility of pension reform is greatly enhanced if the government is backed by at least one of these actors.

A striking finding is that the willingness of an opposition party to arrive at a pension consensus with the government strongly depends on its strategic calculus. An opposition party is unlikely to support the government's pension plans if

this seriously damages its electoral prospects and, specifically, its chances to regain power. Thus, in the context of fierce party competition, the emergence of a broad cross-party consensus appears to be rather unrealistic even if pension policy positions themselves may be relatively similar. However, *if* a broad cross-party agreement on pension reform is negotiated, the adjustments obtained may be relatively far-reaching.

Interestingly, we observe a higher number of pension reforms concerted between government and trade unions than between government and parliamentary opposition. On the one hand, unions' pension policy positions are mostly much closer to the status quo than those of the government irrespective of the latter's general political orientation. On the other hand, unions are typically not engaged in direct political competition with the parties in government. If they receive at least something in return and if they lack the power to prevent the government from imposing a reform unilaterally, trade unions may accept an agreement even if they consider it less attractive than the status quo (because a unilateral reform outcome might be even worse). By contrast, if unions are capable of blocking the reform, the government will be obligated to win union approval by offering more or less far-reaching concessions.

## Notes

- 1 It should be noted that Figure 3.1(b) displays the spending projections based on the legal status quo in 2000. After 2000, further substantial cost containment reforms in the pension systems of these countries have been adopted. As a consequence, Figure 3.1(b) even underestimates the progress in containing public pension expenditures that has been achieved since the late 1980s.
- 2 The opposition may also criticize the lack of initiatives for containing rising pension costs by arguing that the government has done nothing to prevent higher pension contributions rates.
- 3 Many changes in pension legislation only become fully effective after very long transition periods. As a consequence, the full implementation of pension reform will only be guaranteed if subsequent governments are willing to retain these measures.
- 4 These conditions are not self-evident. In a consociational democracy like Switzerland, for instance, all of the relevant parties are represented in government regardless of their vote shares. Another possibility is a party system, in which the governing parties can rely on a strong structural majority within the electorate and thus do not have to fear that they will be voted out of office.
- 5 In principle, the members of a coalition government have similar (or even stronger) incentives for finding compromises as they share a common interest in retaining office. For a small coalition partner this may even imply the reluctant acquiescence in a reform that runs contrary to its policy interests.
- 6 In the German metal workers union (*IG Metall*) the median age is about 53 (Streeck 2002).

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## 4 How do politicians get away with path-breaking pension reforms?

The political psychology of pension reform in democracies

*Einar Overbye*

An influential hypothesis in the welfare literature states that pensions are so popular they can never be significantly cut back. Another influential hypothesis states that policy change is 'path-dependent'. Recent pension reforms suggest that both hypotheses are wrong. Pension reforms during the 1990s were often path-breaking rather than path-dependent. Reforms included benefit cuts as well as dramatic design changes. The article traces pension reforms around the world, and discusses factors that facilitate path-breaking reforms. Since most voters are not well informed on policy issues, path-breaking reform can succeed if politicians are able to frame their proposals as the ones sensible and considerate people should adopt. Hence the study of framing, and political psychology more generally, should be brought into the study of welfare reforms.

### **Pensions can be reformed, and reforms are not always path-dependent**

Public old-age pensions provide security against the risk of longevity, that is, the risk of living so long that private resources dry up. Most voters are inclined to regard themselves as high risks with regard to this social risk (hoping to live longer than average, or at least to live beyond pension age). At the same time, the old are the core group of what used to be called the 'worthy poor'. For these and related reasons, old-age pensions should be the most widespread and popular social security schemes around. Of 172 United Nations (UN) member states, 166 had old-age pension systems in 1999 (SSA 1999). In comparison, about 75 per cent of these countries had public health or maternity insurance, 50 per cent had some type of family benefit(s), and 40 per cent had unemployment insurance (at least for some segments of the workforce). In many countries, the welfare state is little more than a pension state. In the European Union (EU), in particular in Southern European member states, public pensions are the dominant items in the social security budget. Italy during the 1990s was an extreme case. In 1997, 71 per cent of Italian social expenditures consisted of old-age, disability and survivor's pensions (Eurostat 1999). Northern Europe spends relatively less on pensions than Southern Europe. Sweden spent 51 per cent on pensions in 1997 (although of a larger social security budget).

Given the popularity of pensions, an influential hypothesis in the welfare literature has been that pensions, once introduced, can never be significantly reduced. To cut pensions, it is argued, is political suicide. This is a theoretically well founded hypothesis. It is also able to meet the Popperian criteria for a scientific hypothesis: it can be falsified. If one or several countries successfully cut public pensions, the hypothesis is wrong.

During the 1990s that was precisely what happened. Originating in Latin America, large-scale pension reform spread to Central and Eastern European countries, and on to EU member states – to Sweden and Italy in particular. Later, incremental reforms have also appeared in other member states, such as Germany. Thus the hypothesis is wrong: pensions can be cut. We therefore witness the vindication of an alternative hypothesis: everything that is made by politicians, can be unmade by politicians.

The pension reforms of the 1990s have also thrown doubt on another fashionable hypothesis: that policy change is ‘path-dependent’. Path dependence connotes that the structure of previous institutional arrangements impact on how reformers perceive political alternatives; that they structure the field of vested interests reformers find themselves in; that they delineate what is possible to achieve in any existing political configuration, and so on. With particular regard to pay-as-you-go based pensions, the fact that one generation will have to pay twice (once to finance the pension claims of older generations and once to fund their own pensions) is assumed to create a lock-in effect that prevents a shift to a funded pension system.

The path-dependence hypothesis is less precise than the no-cutbacks-are-possible hypothesis. Actually, it is doubtful if the path-dependence hypothesis passes the Popperian test of being a scientific (falsifiable) hypothesis. Path-dependence is a fuzzy idea, and fuzzy ideas are difficult to prove wrong. A true believer will always be able to point to some continuation of previous institutional designs, and save the hypothesis from falsification, no matter how dramatic a break with the political past takes place in any particular country. However, if path dependence is to mean something more than platitudes like ‘history matters’, pension reforms of the 1990s have also weakened this hypothesis. When Sweden and Italy changed their pension systems, they moved from pay-as-you-go defined-benefit systems to notional and/or partially funded defined-contribution systems. This change must not *necessarily* be regarded as a break with the past, since both countries still maintain earnings-related public pensions (although of a totally different design). But then again, if this design shift is not sufficiently dramatic to be recorded as mainly on the not-path-dependent side, what is?

Moving outside EU, the not-path-dependent nature of pension reform is even clearer. The massive shift away from pay-as-you-go defined-benefit schemes to (sometimes fully funded) defined-contribution schemes in Latin America can be labelled many things, but hardly path-dependent, unless the concept is watered down to something which is trivial and non-falsifiable.<sup>1</sup>

Post-1990s political science trying to make sense of pension reforms thus

faces two challenges. First, how to explain why cutbacks in public pensions are indeed possible. Second, how to explain under which circumstances pension reform implies a break with past pension designs, rather than to be a path-dependent continuation of previous designs. The purpose of this article is to suggest answers to these questions. I start with the path-dependence argument and deal with cutbacks as I go along.

Before setting off, however, it should be emphasized that this chapter is concerned with path dependence perceived as a specific *hypothesis*. Namely, that the design of a public pension system will never be radically altered once it has become well-established; that is, that the basic structure will remain recognisable for future generations, and all change will be incremental. This interpretation is in line with the intuitive definition of the concept. It is rather different, however, from Pierson's terminology in his influential article (Pierson 2000). Pierson treats path dependence as a general *approach* to the study of political change. I have few quarrels with the many theoretical assumptions Pierson puts forward in his interesting article. However, approaches are not testable as such, and there is a long way from the theoretical assumptions underlying an 'approach' to testable implications. For the purpose of this article, path dependence is defined as a *specific hypothesis* about political change, not as a *general approach* in the study of political change.

### About path-breaking and path-dependent pension reforms

Beginning with Chile in 1981, many Latin American and Central and Eastern European countries have downsized former pay-as-you-go based systems, and have replaced them wholly or partly with funded pension schemes. This change also involved a shift from defined-benefit to defined-contribution pension schemes. In defined-contribution pension schemes, contributions are typically defined as a percentage of earnings, and benefit levels depend on the number of contributions, plus accrued interests. Argentina (1994), Bolivia (1997), Colombia (1994), El Salvador (1998), Mexico (1997), Peru (1993) and Uruguay (1996) have changed their mandatory pension systems along these lines. So have Bulgaria (2002), Croatia (2002), Estonia (2002), Hungary (1998), Kazakhstan (1998), Latvia (2001), Lithuania (2004), Poland (1999) and Slovakia (2005) (Gillion *et al.* 2000; Overbye 2001; Mesa-Lago and Müller 2002; Chapter 5 this volume).

The shift to funding and defined-contribution has been more pronounced outside OECD than among OECD countries. Most OECD countries still maintain pay-as-you-go based pension schemes where 'contributions' are de facto earmarked taxes. These schemes are usually based on the defined-benefit principle: the pension level is calculated as a percentage of final or average earnings (or average earnings during last five years); usually between 60 and 70 per cent of the earnings base. In such schemes, the link between formal contributions and benefits is much looser than in defined-contribution schemes. Few EU countries have made equally path-breaking pension reforms. In the EU, most pension

reforms have been incremental: introducing less generous indexing rules, extending contribution periods, increasing formal pension ages, limiting access to early retirement schemes. However, two EU countries – Sweden and Italy – have redesigned their public pension systems somewhat along the lines of the new defined-contribution schemes emerging in other parts of the world. Sweden and Italy have scrapped the defined-benefit principle and introduced schemes that, at least nominally, are tied to the number of contributions an individual makes during his/her entire working career. The Swedish system also includes a genuinely funded component invested in financial markets.<sup>2</sup>

How were these across-the-board changes in pension designs made possible? Two levels of analysis should be singled out: structural factors and psychological factors.

### **Structural factors that facilitate path-breaking reforms**

#### ***Limited coverage, and inefficient administration, makes it easier for political reformers to move outside the path***

In many Latin American countries, relatively small groups had initial access to public pension benefits (Gillion *et al.* 2000: 533ff.). Because of large informal sectors, many Latin American workers were not covered by public retirement schemes in the first place. The same goes for the self-employed. Minimum contribution periods were often long. For example, in the Argentine defined-benefit scheme, a worker had to contribute for 30 years to receive a pension from the defined benefit scheme, although an advanced-age benefit could be received at age 70 provided ten contribution years (Gillion *et al.* 2000: 537). If large groups are outside the public pension scheme to begin with, path-breaking reforms will meet less resistance. At least in Bolivia (where only 12 per cent of workers were covered by the old scheme), the new defined-contribution schemes extended coverage to larger groups of workers (although contribution evasion is widespread) (Mesa-Lago and Müller 2002: 702). Vesting periods are also generally shorter in the new defined-contribution schemes. Besides, to the extent that the new schemes are strictly contribution-based (no tripartite financing), no tax money is directed from taxpayers (including outsiders without pension coverage) to ‘insider’ groups.

A related factor why radical reform, and shift to defined-contribution schemes, has been more widespread outside the OECD, concerns the administrative efficiency of the old schemes (World Bank 1994: 149). Fraud and mismanagement is in principle easier to deal with in defined-contribution than in defined-benefit schemes. A defined-contribution scheme provides a clearer link between money in and money out. If incoming money should be lost somewhere along the way, individuals can take legal action against the administrators. This is more difficult in pay-as-you-go based defined-benefit schemes, where there is no formal link between contributions and benefits – no name tag that follows the money as it moves through the administrative apparatus.<sup>3</sup>

Another factor concerns the promise of defined-contribution schemes to boost savings and develop financial markets. Pension funds can form the core of a larger internal capital market, which will have positive effects on resource allocation. Many developing countries lack an internal capital market. This argument has less merit in OECD countries, where capital markets are already well developed.

Finally, a defined-contribution scheme may limit certain types of strategic behaviour prevailing in some defined-benefit plans. If a defined-benefit scheme is based on final salary and only requires a limited number of contribution years, people may be tempted to work only the minimum number of qualification years and spend the rest of their work life in the informal economy (avoiding contributions and taxes), only to re-enter as full time employees at the end of their career to maximize final salary. This behaviour is not possible in defined-contribution schemes. Again, this free-rider problem may be more widespread in countries where the informal economy is large relative to the formal economy.

The above factors help explain why path-breaking reform – with the exception of Sweden and Italy – has taken place only outside the OECD. These factors work at two levels: the level of narrow self-interest and the level of public discourse. First, these factors limit the number of voters who have an interest in the continuation of the old schemes. Second, these factors make it more difficult for supporters of the old schemes to come across as champions of the collective good, and rather enhance the risk that they are seen as spokespersons of privileged groups and/or inefficient managers. While advocates of change have a better chance to be perceived as those who speak for underprivileged outsiders, rather than to be perceived as selfish politicians bent on depriving worthy pensioners of their bread and salt.

### ***Economic crises facilitate path-breaking reforms***

An economic crisis prior to, or during, a reform process, helps. Crises-conscious voters often support politicians who demonstrate initiative and ability to act. The more intense the crisis, the easier it is to advocate dramatic, path-breaking reforms and get away with it. In Latin America, at least the pension systems of Argentina, El Salvador, Mexico and Uruguay were de facto bankrupt or close to bankruptcy before the reform (Mesa-Lago and Müller 2002: 694, 696, 697, 699). The benefit-of-crises argument also explains the path-breaking pension reforms in Central and Eastern Europe, following the regime shifts and the economic recessions that accompanied regime shifts. In many Central and Eastern European polities, runaway inflation combined with inadequate indexing (due to tight government budgets) eroded confidence in old-style public pension provision. General mistrust in the state fuelled support for private or quasi-private alternatives, in countries where the private sector is not (yet) discredited to the same extent as the public sector. In EU, the very high costs of the Italian system (referred above) were important in creating a political climate favouring change. And Sweden hit its worst post-war

recession in the early 1990s, creating a 'something must be done' atmosphere among the political elites.

***High interest rates and stable future prospects make defined-contribution schemes more popular***

Public pensions demand a long time horizon. The time from when first contributions are paid till the last benefits are taken out may well span 60 years. Only if financial markets appear stable, and positive interest rates are seen as the 'natural' state of affairs, do funded defined-contribution schemes have a chance to be more popular among voters than pay-as-you-go defined-benefit schemes. Until the mid-1980s, the historical experience of most countries was not favourable for those advocating funded defined-contribution schemes. The twentieth century experienced two world wars, punctuated by a general depression and followed by a long period with administered low interest rates in many countries. To provide even a simple annuity through funded systems in those circumstances was difficult, to say the least.

This changed in the 1980s. During the mid-1980s, most OECD countries abandoned administrative controls on credit markets (if they had such controls in the first place), ushering in an era of larger international capital flows and higher real interest rates. Real interest rates have been positive since the mid-1980s, following the high inflation years of the 1970, when real interest rates were often negative. Between 1990 and 1999 real interest rates were exceptionally high (Gjedrem 2005). After the fall of European communism in 1989–1992 the world may also appear calmer and more predictable, in the sense that a new world war seems unlikely in the immediate future. These factors probably lead many voters to discount the risk of a future sharp drop in real interest rates, and/or war-induced destruction of the credit system, while simultaneously being tempted by the possibility of high future interest rates. Pay-as-you-go defined-benefit schemes secure against the risk of future low interest rates, since it is the power to tax which ultimately secures the pension promise. But these schemes also lack an upside, in the sense that if interest rates stay higher than expected, this does not lead to higher pensions. If voters believe (or are led to believe) that real interest rates will stay high in the future, they may prefer funded defined-contribution rather than pay-as-you-go defined-benefit pension schemes.

A related factor concerns the rise in stock market values, also peaking in the 1990s (Gjedrem 2005; Trovik and Vikoren 2003: 56). The stock market boom of the 1990s held the promise that funded defined-contribution schemes invested in the stock market would provide the population with higher benefits relative to contributions/taxes than the old pay-as-you-go defined-benefit schemes.

The Swedish pension reform was agreed on 'in principle' in 1994, and was introduced by parliament in 1999. The somewhat similar Italian pension reform (the Dini reform) took place in 1995. The period 1994–1999 coincides with extraordinarily high interest rates plus a stock market boom. This provided a

window of opportunity for actors advocating path-breaking reform. In a world of high interest rates and booming stock markets, funded defined-contribution schemes promise to give everybody higher future pensions, at lower contribution rates. The point is not whether this sanguine view bears out: the point is whether it is shared by a sufficiently large group of politicians, opinion leaders and (ultimately) voters, at the time the reform proposal is going through the politicized stage of the decision-making process.<sup>4</sup> If optimism is sufficiently widespread, advocates of change may succeed in framing a shift from defined-benefit to defined-contribution as a something-for-nothing opportunity: lower contribution rates today plus higher benefits tomorrow. As the Thomas-theorem says: if people believe that a situation is real (here: that interest rates will stay high), then it is real, in its consequences (here: a path-breaking pension reform wins support in parliament).

### *Path-breaking change can lessen resistance to cutbacks*

The Swedish and Italian reforms have been effective in creating future cost-control, since the shift to defined-contribution schemes freezes the amount spent on pension (the contribution rate) as a percentage of wage costs. Hence not only is future relative growth in pension contributions slowed down – it is eliminated. Since the population is steadily ageing, pushing up pension costs, this freeze on contributions might lead to reductions in annuity payments per pensioner in the future. A fascinating thing about the shift to defined-contribution schemes, however, is that it is not *certain* that benefits will be lower in the future. Since the whole point of defined-contribution schemes is that benefits are not determined in advance, no one – at the time the new scheme is introduced – can say for certain that the new pension design is a less generous design. That depends on future interest rate developments. If interest rate projections are sufficiently optimistic (and in the 1990s many were very optimistic), future benefit levels can in fact increase. Thus by abandoning the old scheme and introducing a brand new scheme, Swedish (and Italian) political elites dampened protests more effectively than if they had incrementally changed benefit formulas in the old schemes. The point is that path-dependent design change is not always the design change that encounters least resistance. A major lesson from the Swedish reform can be stated as follows: if you want to change a pension system, it can be wise to change everything at once. This makes it difficult, even for experts, to say who ends up as winner or loser. If no one is sure if they win or lose, resistance to change is minimized. Thus in certain historical configurations, not-path-dependent change is more likely to survive the politicized phase of a reform process than path-dependent, incremental design changes where it is easier to calculate who gains or loses. Mesa-Lago and Müller (2002: 712) point to something similar when they argue that ‘strategic bundling’ of reform packages increases complexity and lowers visibility, making it more difficult for interest groups or voters to determine if they win or lose (see also Pierson 1994: 21).



## The political psychology of pension reform

It is unlikely that similar path-breaking reforms as in Sweden and Italy will take place in other EU countries. After 1999 real interest rates have been reduced, and the volatility of stock markets was demonstrated in the downturn at the end of the 1990s (Gjedrem 2005). Pension reforms in other EU countries appear to be more incremental. Cuts are implemented by changing benefit formulas, extending contribution periods and moving to less generous indexing, rather than to turn the whole system upside down. For example, Spain has extended the number of contribution years from 20 to 25, and the reference period for benefit calculations from eight to 15 years (Gillion *et al.* 2000: 585). Extensions of contribution years and/or reference periods have also taken place in Austria, Finland, France, Greece and the UK (Gillion *et al.* 2000: 585–586; George *et al.* 1999: 47ff.; Chapter 2 this volume). By extending the number of contribution years and using career average rather than final salary as the reference period, defined-benefit schemes become more similar to defined-contribution schemes as far as the relationship between life-cycle earnings and future pension benefits is concerned.

An argument pursued earlier in this article is that incremental reforms might be *more* difficult to implement than path-breaking change, since voters – as well as opinion leaders – are then more able to calculate if they gain or lose. Why have incremental cutbacks nonetheless been successfully implemented in many EU countries? More generally, what are the political mechanisms mediating between structural factors (as outlined above) and the parliamentary decisions to change pension systems? Favourable structural conditions for change must be *perceived* by agents of change in order to work, and they must be convincingly *presented* for others in order to work. Structural factors never produce political decisions by themselves; they only work by influencing how people think and act. How people think and act are essentially psychological questions. Let us move attention, then, to the political psychology of pension reform.

### *Mass politics: winning the defining-the-situation game*

Although voters love pensions, they love a lot of other things as well. Considering the ageing of the population in most Western countries (plus in many Eastern countries), pension costs will grow automatically unless pension generosity per claimant is cut back. Pension cuts are not correlated with *reduced* pension spending; they are correlated with a *slowdown in the growth* of pension spending. Advocates of change can argue that pension spending threatens to crowd out other types of public spending, and legitimate cutbacks by pointing to the desire to maintain other types of government spending. If a majority of voters accepts this way of framing the issue, cuts can be made more acceptable in the general population. Similarly, if cuts for ‘insider’ groups are linked to increases for less well off ‘outsider’ groups, it is possible to present reforms as creating a more equitable overall system.

The general point is that successful pension reform (be it path-dependent or not) depends on what emerges as the dominant 'definition of the situation'. Is the situation defined in such a way that a responsible and caring person is assumed to support the reform, in order to make room for even worthier social programmes, plus secure the long-run stability of the economy? If this emerges as the dominant definition of the situation, resistance to the reform will be limited. Or is the defining-the-situation game won by those who portray supporters of reform as selfish taxpayers who do not even want to grant the worthiest of the worthy poor (the old) a decent living standard? If so, the reform will probably meet widespread opposition.

The defining-the-situation game is pivotal also with regard to the expected vote loss/vote gain of pursuing pension reform, since the act of voting in an election has more in common with a speech act (expressing a political opinion) than with 'costly' individual decision acts (such as buying a new car or a house). It costs next to nothing to vote, just as it costs nothing to offer a political opinion. And since a vote is usually only one in millions, an individual vote has next to no effect on the outcome of an election. From an individual cost-benefit perspective voting acts, as well as speech acts, are *low costs/low benefits* acts. It is easier to influence low costs/low benefit acts than it is to influence acts where individual costs and benefits are higher (as when buying a car or a house: the costs involved when performing such acts are higher, and so are the individual consequences of making a wrong decision). This insight is the point of departure for an important tradition in political science, arguing that most voters are 'rationally uninformed' on political issues, and that voting acts are consequently heavily influenced by how opinion leaders frame the issues (Schumpeter [1942] 1996: 261–262; Downs 1957: 244–247; Converse 1975: 93–94; Brennan and Buchanan 1980: 22–23, 28ff.). As a follow-up on this view, the similarities between voting acts and speech acts implies that chosen positions are probably determined by what people perceive as the *socially desirable* position to take. A main rationale for performing low cost/low benefit acts, including speech acts as well as voting acts, is to signal to one's peer group(s) opinions and views regarded by others as acceptable, thus enhancing one's reputation as a person others can trust (Overbye 1995). Empirical studies of political opinions have indeed found a strong social desirability bias in the opinions people express (deMayo 1984). Thus public opinions about pension reforms (and subsequent voting) are probably strongly influenced by how such reforms are framed, that is, whether they are framed as socially desirable or not socially desirable. The emerging study of political persuasion and attitude change show several examples of this effect (Schuman and Presser 1980; Smith 1984; Iyengar 1990; Kuklinski and Hurley 1996; Chong 1996). The implication is that the vote gain/vote loss of advocating pension reform is less predictable than is commonly assumed in the structuralist/institutionalist school of thought.

As an illustration of the importance of the defining-the-situation game, consider the following example: in 2003 a random sample of Norwegians aged

18–74 were polled about their opinions on pension reform. The issue was if Norway should scrap its existing earnings-related system and maintain *only* a flat-rate basic pension (like the present Danish system), or on the contrary bolster the earnings-related system by forging a clearer connection between contributions and benefits (similar to the reformed Swedish system). Half of the respondents were asked a question framing the issue as a question of creating equality between pensioners. The other (randomized) half of the sample were asked a question framing the issue as a question of creating equality between what a person pays and what he/she gets. Since the groups were randomized, differences between the two groups accurately measure the effects of framing (in other words, defining the situation differently).

Respondents in the first group were asked their opinion of the following statement:

The public pension system should not give some people more than others. Those who have earned little or nothing during their working life, should get as much as those who have earned a lot.

The result showed that 54 per cent of respondents agreed that the public pension system should not give some people more than others. This implies supporting a flat-rate pension system. A remaining 44 per cent disagreed.

Respondents in the second group were asked their opinion of an alternative statement:

Those who have paid high taxes during their working life, should get a higher public pension than those who have paid less tax.<sup>5</sup>

In this case, 62 per cent of respondents agreed that this was fair, which implies supporting an earnings-related public pension system. A remaining 37 per cent disagreed. Thus while the first frame produced a majority that supported flat-rate public pensions, the second frame produced a majority that supported earnings-related public pensions. Since the two groups were drawn at random, this difference in expressed opinions is a pure framing-effect (Bay 2005: 16–18).

For a policy reformer, framing is a double-edged sword. It can make it easier to gain popular acceptance of pension reform, if one has the skill and luck to win the defining-the-situation game. But it can also make it more difficult to gain acceptance of a reform, if one's opponents are more skilled in this respect. From a political science point of view, framing induces an element of *unpredictability* on the political scene, and makes it more difficult to guess in advance if a pension reform that has been successful in one country, will also be successful in another country. It is not sufficient to investigate if the underlying social and economic structures are similar; one should also look into the rhetorical qualities of the opponents, as well as their degree of media control. Politics is not only a science, it is also the art of impression management. (Then again there is also a science of impression management.)

*Elite politics: a question of trust*

The framing-argument outlined above underlines the importance of elite consensus, not only among political parties, but also among trade unions, newspaper editors and other opinion leaders. If these groups can be taken on board, not only have disaffected voters nowhere else to go, they are also less likely to perceive themselves as disaffected in the first place. If all opinion leaders jointly frame the reform as 'desirable', or at least 'unfortunate but necessary under the circumstances', the rationally uninformed starting point of most voters, plus their reputational interest to be seen as holding socially desirable views, limit the risk that they become frustrated in the first place. Zaller (1996: 52ff.) convincingly argues that if most parties and media agree how to frame an issue, media effects on political attitudes are very strong (and much stronger than in situations without party or media consensus on how to frame an issue). When the views of political elites and mass media converge and barrage the public, public opinions can shift very rapidly even on the desirability of war or peace; and probably more so with regard to less dramatic policy questions, such as pension reform. The question then becomes under which circumstances political elites do agree to bury the hatchet and cooperate, rather than to use any opportunity to criticize their political competitors.

Perhaps this is partly a question of political culture. Wilensky (2002: 83) draws a distinction between corporatist and fragmented political economies (somewhat similar to Lijphart's (2001) distinction between consensus democracies and majoritarian democracies). According to Wilensky, corporatist political economies employ peak-level bargaining arrangements where labour and social policy issues are intertwined. The political culture is characterized by compromise and give-and-take. Fragmented political economies adopt a less integrated and more confrontational political style. It is easier to get consensus on certain frames if politicians, trade unions and media are used to cooperation, and trust each other not to break informal deals even if there should be short-term (vote) gains from defecting. The small Scandinavian democracies are famous for such political arrangements, which a less charmed observer than Wilensky labelled someone-have-talked-together democracies.<sup>6</sup> This tradition of talking together may further explain why Sweden introduced a more radically path-breaking pension reform than any other EU country. The Swedish pension reform was facilitated by a high-level, interparty working group which met between 1992 and 1994 and prepared the reform proposal. Lundberg (2001: 30–31) describes the working arrangement as follows:

The will to compromise was apparent in the way the pension committee worked, which in my interviews was described as very close/confidential (*fortroendefull*). The idea was first to agree in the committee. Then the agreement should be anchored in the respective party leaderships. Only after that should mass media and the general public be informed. [The shared opinion was that] No one would win on a new principled fight over

pensions. Thus the desire was to keep the discussions of the working group away from the public at any price. Even the internal discussions in the parties were held under strict control ... Officially the committee did not work to create a new system but to 'reform', 'improve', and 'modernize' the old. The Social Democrats made this an absolute condition for even considering participating in the committee. It was strictly ruled out even for the Conservatives to say something different.

(Author's own translation)

Within-group psychology also played a part in bringing about the path-breaking outcome. It turned out that the members representing the two most antagonistic parties, the Social Democrats (Anna Hedborg) and the Conservatives (Margit Genser), liked each other. As Hedborg herself put it:

I think it played a role that Margit Genser represented the Conservatives. She is a very independent and systematic person. She loves logic. If you challenge her with a very logical line of reasoning she cannot resist it –and I am a little like that too. Könberg [representing the Liberal party] is also a bit like that. We are all very issue oriented, somewhat engineering types ... Somehow I think it was a very lucky mix of persons. Both that we were the persons we were and then not more than us.

(Quoted by Lundberg (2001: 32), author's own translation)

Lundberg argues that this favourable personal chemistry created a 'we' identity among the committee members, and made them define the situation so that 'we' have to convince 'them' (the leaders of the respective parties) that 'we' are right. This bonding between high-level committee members, making them present a united front vis-à-vis outsiders, is rare even in Scandinavian politics. It probably helped bringing about the path-breaking outcome. It is a factor difficult to reproduce in other settings, yet again illustrating the element of unpredictability that psychological factors induce into a policy-making process.

Italy is a far less consensual democracy than Sweden. But also in the Italian reform there were traces of similar processes. Natali and Rhodes (2005) present Italian reforms as a 'stop-go' process of consensus building. The 1995 Dini reform was shaped in close dialogue with trade unions. The follow-up 2004 Berlusconi reform was moulded in a stop-go fashion, where 'the government proposed new measures, stepped back in the face of union opposition, and engaged in several months of policy diplomacy before relaunching the process with a modified proposal addressing some union concerns' (Natali and Rhodes 2005). Mesa-Lago and Müller (2002) point to several similar instances in their analysis of pension reform in nine Latin American countries.

The main point is that elite-elite interaction during a reform phase involves a complex social process, where actors must find out if they can trust opponents to stick to informal deals. The core structure resembles an assurance game. Each elite will be wary if they can trust other elites to cooperate, rather than to defect

and reap the benefits of attracting disaffected voters. Reputations for being cooperative or uncooperative (which depend on political culture and traditions) act as signals in this game. In addition to reputations, elites can employ strategies such as self-binding (publicly announcing their intentions), bonding and reputation-building (for example, engage in joint committees) to signal their intentions to other players (where deception may also be part of the game). It must be borne in mind that the world of elite politics is somewhat similar to a village community, in the sense that most people know each other and expect to meet and interact also the day after the reform. Hence social controls (including the risk of social ostracism) discourage blatant disloyal behaviour, and help make informal agreements stick.

### **Implications for welfare theory**

In the 1950s and 1960s, when welfare spending was on the increase everywhere, the ‘logic of industrialism’ thesis claimed that relative increases in welfare spending (including pension spending) was an inevitable aspect of a general and worldwide modernization process (Marshall 1950; Wilensky and Lebaux 1965). After the first oil price rise in 1973 and the following years of stagflation (high inflation plus high unemployment), the issue became if the welfare state was in crisis, in other words, if existing levels of public welfare spending were unsustainable. However, welfare spending was not particularly responsive to worsened economic performance, and continued to grow during the 1970s and 1980s. This spurred the ‘democratic overload’ literature, arguing that democratically elected politicians were unable to stand up to pressure groups, resulting in chronic budget deficits (Britain 1975). The path-dependence hypothesis, as specified in the introduction, can be interpreted as a neoinstitutional version on the ‘democratic overload’ argument. Democratic-overload theory argues that elected politicians are no match set against lobby groups and electorates, while the path-dependence hypothesis assumes that elected politicians are no match set against the dead weight of existing institutional arrangements. Humans are locked into an institutional iron cage, where the weight of previous institutional solutions narrows the political path to a one-way street we have no choice but to pass along. Although it can be discussed if high and rising pension costs are good or bad, locked-in politicians hardly have any choice in the matter. The point of agreement between these traditions is that the show is run by others than ruling politicians themselves. (There may be a difference in mood, however: some ‘democratic overload’ scholars become politicians and argue that core political institutions (such as treasuries) should be isolated from electoral control, while the path-dependence hypothesis lends itself more easily to a fatalistic world-view, ruled by structures with little room for conscious agency left, right or centre.)

But in the 1990s, we actually witnessed a levelling-off of welfare spending across OECD countries (Gilbert 2002), plus a surge in reformed pension designs, and/or cutbacks, in an even wider circle of countries. This development

represents a challenge for democratic overload theory as well as the path-dependency hypothesis. On the face of it, the changes that took place in the 1990s (and continue to take place in the 2000s) suggest that democratically elected rulers have considerable room for manoeuvre both relative to derived institutional structures and interest groups.

The argument pursued in this article has been that the scope for elected politicians to change policies is quite large. The basic reason for this is that most voters, most of the time, are rationally uninformed about the exact content of political issues (due to the low cost/low benefit character of individual voting acts). Limited initial knowledge implies that large groups of voters can be persuaded by whatever new pieces of information that drifts their way, plus by how this information is framed. The impact on public opinion is particularly large if political elites agree to present (frame) reforms in the same way.

Is a large room for manoeuvre on behalf of elected elites good or bad news for democracy? It can be both. Brennan and Buchanan (1980) compare voters to onlookers at a football match, and argue that voting is motivated by entertainment and/or expressive benefits, similar to the joy of cheering for one's favourite team. If this is correct, there is a risk that voters may be swayed by expressive sound-bites and manipulated into supporting policy reforms they ought to resist. My alternative assumption, pursued here, is that voting has more in common with situations where people talk about politics, than situations where they cheer at football teams. In situations where people talk with each other about politics, most people will try to convey an image of a well-meaning and concerned citizen to their interaction partners; although there may be variation between social groups (Overbye 1995). If this is correct, voters should be particularly influenced by reasoned arguments about the common good (or at least the common good of their interaction partners!), and this is what 'political persuasion' ideally should be about. Both views converge, however, in arguing that politicians need not be obsessed with the economic benefits different voters derive from various reform proposals – partly because voters have limited incentive to pay the information costs to know their narrow economic interests in the first place, and partly because voters have a reputational interest not to be seen by others as concerned only about their own narrow economic interest. In sum, the pension reforms of the 1990s and early 2000s indicate that democracies as political decision-making systems are capable to push through path-breaking as well as path-dependent pension reforms. To end with a positive definition of the situation: democracy is not a fragile system that works only on sunny days.

## Notes

- 1 If everything is path-dependent, the hypothesis becomes a tautology. A hypothesis that explains everything, explains nothing.
- 2 Changes in pension designs not only encompass public pensions. Within the OECD, an ongoing change in private (voluntary, supplementary) pensions topping up public pensions also indicates a change in pension designs. At least in Australia, Austria, Belgium, Denmark, Germany, Greece, Ireland, the Netherlands, Spain, Switzerland,



Sweden, the UK and the US, occupational pensions based on a defined-contribution principle are increasing their market share at the expense of old-style funded defined-benefit plans, which dominated the occupational pension sector in the past (Dent and Sloss 1996).

- 3 A factor working in the other direction is the high administrative costs to run funded defined contribution schemes. However, if several administrators have to compete with each other for the right to administer the funds, competitive pressure should at least in theory weed out the most fraudulent and/or incompetent of them.
- 4 In his splendid analysis of the first (1959) Swedish pension reform, Molin (1965) distinguishes between a not-politicized and a politicized stage in a political process. In the non-politicized stage, political initiatives move around between actors and agencies in the form of sketches, drafts, research and committee reports. A political initiative usually enters the politicized stage (if at all) when it is put on track to become a decision in parliament, in particular if clear alternatives are formulated and communicated to the public, and the parties position themselves differently. The Swedish 1959 reform was extremely politicized. Dissolution of parliament, a referendum and new elections were necessary before the Social Democrats were able to squeeze their proposal for mandatory earnings-related pensions through parliament against vehement opposition from the non-socialist parties (a renegade from the Liberal Party secured the one-vote majority). The defeat divided and discouraged the non-socialist parties for at least a decade, while the '1959 pension victory' got almost mythical status in the Social Democratic collective memory. Nonetheless, despite the tremendous political prestige the Social Democrats had invested in the 1959 reform, they were willing to reach a broad consensus when – in 1992 – the leadership of the party had become convinced that a major overhaul was necessary.
- 5 Own translation from Norwegian of both quotes.
- 6 Personal conversation with unknown scholar from an English-speaking (majoritarian) country at a conference some time in the 1990s.

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# 5 The politics and outcomes of three-pillar pension reforms in Central and Eastern Europe

*Katharina Müller*

## Introduction

Since the late 1980s Central and Eastern Europe (CEE)<sup>1</sup> and the Former Soviet Union (FSU)<sup>2</sup> have experienced dramatic political and economic changes. These did not leave the area of old-age security unaffected. Interestingly, the paradigm choices made in CEE and the FSU reflect considerable diversity. Many CEE and FSU countries have embarked on parametric reform, thus changing key characteristics of their existing public pay-as-you-go (PAYG) schemes. A number of transition countries have opted for partial or full pension privatization, thereby following the much-advertised Latin American role models (Müller 1999, 2003). Some countries have introduced notional defined contribution (NDC) plans, designed in Sweden and Italy. Overall, contributory approaches to old-age security, whether publicly or privately organized, have dominated the post-socialist pension reform agenda.

This chapter comes in five parts. The first section outlines the pre-1989 legacy in old-age security and the impact of economic transformation on the existing retirement schemes. Then, the different pension reform paths to be observed in CEE and the FSU are reviewed. These include parametric reforms, directed at key features of the PAYG schemes, and systemic reforms, that is, the introduction of NDC plans and prefunded schemes. Thereafter, the political economy of what may be considered the major paradigm shift in the region's old-age security arrangements – pension privatization – is analysed: the advent of the new pension orthodoxy, political actors and the policy context, and reform design. The paper is finalized by some concluding remarks.

## The socialist legacy and the impact of transformation

During the decades of socialist rule, retirement schemes in CEE countries and the Soviet Union were organized along similar lines, without rendering them identical. The central policy measure of the socialist era was the creation of a unified pension scheme, integrated into the state budget and cross-subsidizing other expenditure items. The gradual expansion of coverage, that turned universal by the 1960s or 1970s, was a major achievement of the post-war years. As a

rule, the legal pension age was decreased to 60 for men and to 55 for women, while the effective retirement age was several years lower.

Employees' contributions were abolished in most countries, and employers' contributions became the only source of financing. Contributions were made as a percentage of the total payroll, being interpreted as a wage tax rather than a pension contribution. As there were usually no contribution records at an individual level, the existing contribution-benefit link was weak: pensions tended to depend on years of service rather than on the level of contributions made on the insured's behalf. In a context of high labour participation rates, this implied scant benefit differentiation. Yet, pension privileges – a lower retirement age and higher benefits – granted for occupations of strategic importance marked an important departure from universalism.

The insufficient adjustment of current pensions to price or wage dynamics implied that newly granted pensions were considerably higher than average retirement benefits, giving rise to problems of inter-cohort fairness and of benefit adequacy. In Poland, this problem came to be known as 'old pension portfolio' – the longer a pension was drawn, the lower its purchasing power (Zukowski 1997: 138). Hence, many pensioners continued their gainful employment to top up their low old-age benefits.

The early years of economic transformation affected the existing PAYG schemes in different ways. Price liberalization and the curtailment of subsidies on basic goods and services required a shift from indirect to direct transfers, resulting in rising expenditure for old-age security. Privatizing, downsizing and closing down the state-owned enterprises resulted in a mounting number of disability pensions, while also being accompanied by early retirement policies to disguise the employment effects of structural adjustment. The retirement system was thus used as a substitute for welfare and unemployment benefits. By leading to an increased number of pensioners and a falling number of contributors to the public pension scheme, this policy resulted in a significant destabilization of public pension finances.<sup>3</sup> Moreover, as in all insurance-based schemes, the shrinking number of contributors also translated in plummeting future coverage ratios and thus in a gradual erosion of social insurance protection of the elderly.

While the times of full employment are indeed over in the post-socialist world, intra-regional differences in formal employment rates are considerable. In 1997, only one out of three was still employed in the formal sector in Georgia, Yugoslavia and the Kyrgyz Republic (World Bank 2000). In comparison, labour market trends were far less dramatic both in the European Union (EU) accession countries and in those countries with lower degrees of transition, such as Belarus. Most of the countries in the region were unable to create jobs at sufficient pace to replace those that were lost, hence employment-to-population ratios are currently well below the Lisbon target of 70 per cent and often trending downward (Alam *et al.* 2005). In many places, the main source of employment growth has been the informal sector. Given that the self-employed rarely make pension contributions, the percentage of the labour force still contributing has often dropped dramatically, the extreme examples being Armenia with 27

and Albania with 21 per cent. Some countries even counted less contributors than pensioners, most notably Albania, Georgia and Armenia (World Bank 2000).

Public pension spending was also far from uniform throughout the region. Eight years after the start of economic transformation, only Poland and Slovenia had surpassed the West European average, with pension expenditures amounting to 13.7 and 13.4 per cent of the Gross Domestic Product (GDP). With expenditure levels between 1.7 and 4 per cent of GDP, pension spending was lowest in the Caucasian and Central Asian republics of Georgia, Azerbaijan, Tajikistan and Turkmenistan, where replacement rates hovered between 23 and 27 per cent of average wages. Yet, the differences in pension spending are also accounted for by the heterogeneous demographic background in the region. In Central Asia, the Caucasus, Albania and Bosnia, the old-age dependency ratio was only 7 to 12 per cent, while it amounted to 20 per cent or above in Bulgaria, Hungary, Latvia, Ukraine, Croatia and Estonia (World Bank 2000; Müller 2002c).

### **Post-socialist pension reform paths**

In the course of the 1990s, it had become clear all over the region that the old-age security systems inherited from the socialist past were in dire need of reform, to secure their financial sustainability, to meet the demographic challenges ahead and to adapt to the new economic order. In spite of a rather uniform policy legacy, however, different types of pension reform can be observed in CEE and the FSU. These include parametric reforms, directed at key features of the PAYG schemes, and systemic reforms, that is, the introduction of NDC plans and prefunded schemes. These different pension reform paths are presented in the following.

#### ***Parametric reforms***

It was relatively undisputed among social security experts in CEE and the FSU that essential pension reform measures included a higher retirement age, the abolition of branch privileges, tighter eligibility for invalidity pensions and early retirement, the separation of pension schemes from other social insurance plans and the state budget, and – last but not least – the introduction of an employees' contribution.<sup>4</sup> Moreover, benefits were often closely linked to lifetime earnings in order to introduce more horizontal equity and to improve contribution incentives. For example, Bulgaria, Croatia, Romania, Serbia and Slovakia introduced German-style point systems in the first tier. Yet in a PAYG scheme, a greater differentiation of benefit levels requires extra financial means to improve the financial position of middle and high lifetime earners, if minimum benefits are already very low. Several FSU countries, especially those in Central Asia and the Caucasus, could hardly afford earnings-related pensions and thus spent scarce resources on benefits providing minimal consumption. The introduction of automatic indexation rules amounts to yet another potentially costly measure

presupposing fiscal leeway. Where benefits did not keep up with inflation and/or wage growth, they were often insufficient to prevent poverty. Although parametric reforms have now been implemented throughout the region, a large agenda of outstanding issues remains in most countries, thus calling for a second round of reforms (Castello Branco 1998; Lindeman *et al.* 2000; Holzmann and Hinz 2005).

### *Notional defined contribution schemes*

NDC schemes amount to an interim solution beyond the traditional distinction between defined-benefit and defined-contribution plans. All contribution payments are recorded in notional individualized accounts, where capital accumulation is only virtual. Individual benefit levels depend mainly on past contributions and their notional rate of return.<sup>5</sup> Moreover, future benefit amounts are linked to the development of mortality and the chosen retirement age. Years spent in higher education, military service and raising children can be credited to individual accounts, provided the government assumes contribution payment for these periods. A NDC plan amounts to a fundamental change of the rules within the public tier, tying benefits closely to contributions and automatically adjusting the benefit level to a shortening of the period of contributions and/or an extension of the years in retirement (Cichon 1999; Holzmann and Palmer 2006).

NDC plans, developed by Swedish and Italian experts (Disney 1999a; Franco and Sartor 2003), introduce a quasi-actuarial pension formula to the public tier. In 1996, Latvia was the first transition country to introduce an NDC plan. Meanwhile Poland, the Kyrgyz Republic, Mongolia and Russia have followed suit. The Latvian pension formula can be simplified as:

$$P = C/E$$

with  $P$ =annual pension,  $C$ =total amount of indexed contributions accumulated by the insured, and  $E$ =remaining life-expectancy at the time of retirement. In the case of delayed retirement,  $P$  increases due to both a higher  $C$  and a lower  $E$ . The insured will receive annual statements about paid contributions and on the pension they can expect when retiring at age 60, 65 or 70 (Müller 2002b; Bite and Zagorskis 2003).

Advantages attributed to the NDC approach include a gain in transparency, endogenous adjustment to increases in life expectancy, greater incentives for formal employment as well as late retirement, and a reduction of future pension expenditure (Holzmann 1997; Barr and Rutkowski 2005). As regards disadvantages of NDC plans, they may increase old-age poverty, since they inherently withdraw the commitment to benefit adequacy. As they are essentially functioning on a PAYG basis, NDC plans will run into financial problems when birth rates are falling, unless benefits are indexed to the dynamics of the contribution base. Moreover, as in prefunded schemes, unexpected increases in longevity will

affect current pensions from NDC plans. The instant differentiation of benefit levels intended by the introduction of NDC schemes was hampered by the fact that few CEE and FSU countries kept individual contribution records prior to 1989. Finally, early experience highlights that in order to function at all, an NDC plan presupposes the readiness and ability to make significant investments in sophisticated information technology.

### *The move towards prefunded schemes*

In most CEE and some FSU countries, the early 1990s brought a first change in the funding mix, when supplementary private schemes were introduced on a voluntary prefunded basis. These plans were designed as personal pension accounts or as employer-sponsored occupational schemes. Yet, the amount of voluntary funds collected fell short of expectations, highlighting both income constraints and a widespread mistrust of domestic financial institutions after a series of scandals and crises.

Since 1998, several CEE and FSU countries – among them six out of the eight post-socialist new EU member states – have opted for a more radical move: full or partial pension privatization, thus following the three-pillar approach long recommended by the World Bank.<sup>6</sup> Kazakhstan has remained the only transition country to have substituted its PAYG system entirely with a prefunded scheme. In comparison, Hungary, Poland, Latvia, Bulgaria, Croatia, Estonia, Lithuania and Slovakia have introduced mixed systems by partly diverting pension insurance contributions from the public PAYG scheme to a mandatory prefunded second tier (see Table 5.1). Similar reforms are being prepared in Macedonia, Russia, Ukraine and Romania (von Gersdorff and Rutkowski 2004).

As noted above, the most iconoclastic pension reform was implemented in Kazakhstan (1998), explicitly modelled on the Chilean precedent. All Kazakh workers, regardless of their age, are required to contribute 10 per cent of their gross wage to one of the newly set-up pension funds.<sup>7</sup> Most countries in the region introduced a three-pillar structure, however. Argentine-style partial pension privatization was implemented in Hungary (1998), Poland (1999), Latvia (2001), Bulgaria, Croatia, Estonia (2002), Lithuania (2004–2005) and Slovakia (2005). In these countries, the post-reform pension system is of a mixed type, combining a mandatory public PAYG tier with a prefunded one, while there is also a voluntary third tier.

With the sole exception of Kazakhstan, the first PAYG tier is mandatory for all insured and will cover acquired pension claims, to be topped up by post-reform pension claims if the insured decides to stick to the purely public pension option. The second tier is usually designed as a decentralized prefunded scheme, run by competing private pension funds in charge of account and asset management.<sup>8</sup> The second tier is financed by a contribution rate of 2 to 10 per cent, to be diverted from the first tier.<sup>9</sup> While contributions to the newly created individual accounts are usually financed entirely by employees to strengthen the idea of individual responsibility for old-age provision, policy-makers in Estonia,

Table 5.1 Pension privatization in Eastern Europe and Central Asia

	Kazakhstan	Hungary	Poland	Latvia	Bulgaria	Croatia	Estonia	Lithuania	Slovakia
<i>Public tier</i>	Closed down	Traditional PAYG	NDC	NDC	Pension points	Pension points	Traditional PAYG	Traditional PAYG	Pension points
<i>Private tier</i>	– Prefunded Mandatory	Mandatory Prefunded Mandatory for new entrants to the labour market; optional for all others	Mandatory Prefunded Mandatory up to age 29; optional between ages 30 to 49*	Mandatory Prefunded Mandatory up to age 29; optional between ages 30 to 49*	Mandatory Prefunded Mandatory up to age 42*	Mandatory Prefunded Mandatory up to age 39; optional between ages 40 to 49*	Mandatory Prefunded Mandatory up to age 18*; optional for all others	Mandatory Prefunded Optional for all insured	Mandatory Prefunded Mandatory for new entrants to the labour market; optional for all others
	10% individual contribution rate	8% individual contribution rate	9% individual contribution rate	Individual contribution rate will increase to 10%	Contribution rate will increase to 5% (including employers' share)	Individual contribution rate: 2.5% + employers' contribution: 2.5%	Individual contribution rate: 2% + employers' contribution: 4%	5% individual contribution rate	9% employers' contribution
	since 1998	since 1998	since 1999	since 2001	since 2002	since 2002	since 2002	since 2004/05	since 2005

Source: Based on Müller (2005a).

Note

\* Age thresholds are indicated as of the year of reform introduction.



Bulgaria and Croatia have recently opted for a co-financing of both mandatory tiers by employers' and employees' contributions, and in Slovakia employers even pay the entire second-tier contribution. Upon retirement, the calculation of annuities is based on the total amount of accumulated funds and the remaining life expectancy of the insured.

Membership in the second tier is usually a question of age and/or choice. While Poles, Latvians and Croats aged 50 and over were required to remain in the old system, Poles/Latvians under 30 and Croats under 40 years of age were obliged to join both mandatory tiers. Those between 30 and 49 (Poland, Latvia) or 40 and 49 (Croatia) could do the same or stay in the old public scheme. In Hungary and Slovakia, all new entrants to the labour market were obliged to join the new scheme, while all others who were not yet retired could choose the purely public or the mixed option. In Lithuania, all workers may opt to participate in the second tier, regardless of their age, but are not obliged to do so. Contrary to this, all Bulgarians up to age 42 were required to participate in the second tier.

Currently, the new scheme thus offers a purely public as well as a mixed pension option on a partially optional or mandatory basis. However, given that the young and new entrants to the labour market are obliged to participate in the second tier, the future pension system will contain a mandatory prefunded component for all. Only in Lithuania, future insured may continue to choose the purely public option. Today, between 45 and 80 per cent of the insured already participate in the second tier. With 11.5 million affiliates in 2004, one of the earliest reformers, Poland, had the largest number of fund members, while in the three Baltic states (Estonia, Latvia, Lithuania) the number of affiliates was just about half a million. In terms of the accumulated capital stock, populous Poland also came first, with US\$11.8 million or 5.6 per cent of GDP. By contrast, in Latvia and Bulgaria, where current contribution rates are only 2 per cent and wage levels are low, the capital stock only amounted to 0.4 and 0.6 per cent of GDP, respectively (Müller 2005c).

Advocates of a shift to prefunding claim that the move increases long-term saving and investment and boosts capital market development, resulting in greatly improved macroeconomic growth (World Bank 1994; Corsetti and Schmidt-Hebbel 1997). The strict actuarial relationship between contributions and benefits in prefunded schemes is thought to remove unfavourable incentives affecting labour supply and savings behaviour. Moreover, pension privatization is expected to result in a restriction of the role of the state in old-age security and a reduction of public spending in the long-term. It is also considered attractive due to imputed rate of return differentials between private and public pension schemes (Disney 1999b).

While the mixed reform path promises to diversify the risks inherent in both public PAYG schemes and private pension funds, it should be noted that economic and demographic risks are common to both types of schemes (Barr 2000). Moreover, future retirees may face considerable investment risks since capital markets in transition countries are still shaky. In a context of widespread state

capture<sup>10</sup> they often lack an adequate legal and supervisory framework. Informed choices between the public and the private pension option, as well as among pension funds, presuppose financial literacy (Davis 1998); a less than realistic assumption for the greater part of the population.

Costs are also an issue here. Private pension funds usually charge high commissions, reflecting the costs created by numerous sales agents, substantial marketing expenses and frequent fund-switching. The sum of these charges substantially reduces the share of contributions effectively credited to individual accounts. When internal rates of return were calculated for Poland, Hungary and Latvia, these turned out to be negative (UNFE 2001; Augusztinovics *et al.* 2002; Vanovska 2005). Converting an account into a lifetime annuity generates additional costs.

The total fiscal burden caused by the transition to prefunding in CEE and the FSU will be considerable, since coverage was near-universal under the socialist retirement scheme. As contributions are increasingly being drained away from the public old-age system, the fiscal and political viability of the PAYG tier is likely to diminish in the future, and '[t]he "unsustainability" thus may prove a self-fulfilling prophecy' (Augusztinovics 1999: 102). Moreover, if the prefunded tier underperforms and guarantees are insufficient, governments may find themselves obliged to support the elderly. Hence, even when the pension system is formally defined-contribution, the risk of old-age poverty is ultimately borne by the state, facing sizeable contingent liabilities (Müller 2002d).

### **The politics of the three-pillar reforms: a comparative analysis**

Pension systems have traditionally been considered difficult to reform, as they build up long-term expectations and legal entitlements that are hard to reverse. Moreover, pensioners constitute a substantial part of the electorate, amount to the largest single-issue constituency in many countries and are also viewed sympathetically by other voters, who may perceive being indirectly hurt by cutbacks (Pierson and Weaver 1993). Hence, it has long been thought that 'any pronounced challenge to the basic structure of the system is equivalent to political suicide' (Buchanan 1983: 340). Contrary to this, however, the previous sections have shown that far-reaching pension reform has been possible in CEE and FSU countries. In the following, the available insights on the making of the three-pillar reforms in the region will be presented, including the advent of the new pension orthodoxy, political actors and the policy context, and reform design. The section is based on the comparative analyses in Müller (1999, 2002a, 2003, 2005d), covering the cases of pension privatization in Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania and Poland, and the Czech Republic and Slovenia as contrasting cases of paradigmatic reforms.

*The new pension orthodoxy*

Conservative critics of the welfare state had long prepared the ground for a paradigm change in old-age security, as described by Hirschman (1991). Yet, the cognitive availability of the Latin American precedents<sup>11</sup> was pivotal to turn pension privatization from a theoretical concept into a political reality (Weyland 2004). It was in the wake of the end of the Cold War that the terms of the prevailing discourse in old-age protection shifted, interacting with the rise of neoliberalism as the main paradigm in economic policy-making, particularly in developing and transition countries. Since the mid-1990s, a dominant epistemic community can clearly be identified: a 'new pension orthodoxy' (Lo Vuolo 1996) that has been giving major impulses to pension privatization.

The recent wave of full or partial pension privatization, that is, the adoption of similar blueprints across countries, suggests a common international transmission mechanism of ideas. Although individual Latin American reformers passed their experiences on to East European policy-makers, in person or via their writing, direct diffusion from Chile and other Latin American reform precedents were rather weak in the post-socialist region, with the exception of Croatia and Kazakhstan. Latin America carried the stigma of being a less developed region (Orenstein 2000), rendering it unsuitable as a benchmark. However, Latin American-style pension privatization was recommended as a major reform option by the international financial institutions (IFIs), most notably the World Bank (World Bank 1994; Vittas 1997). While originally not contained in the so-called 'Washington Consensus', pension privatization has since become part and parcel of the neoliberal reform package.

Hence, in Central and Eastern Europe, where the connotations of the 'Chilean model' were more likely to refer to the Pinochet regime than to a regional example of economic success, the IFIs played an important though mostly low-key role as agents of transmission, helping to enhance the low status of the Latin American precedents (Müller 2001; Nelson 2004). Apart from the ubiquitous conditionalities, channels to support pension privatization include loans and an expert-based knowledge transfer – a potentially attractive assistance package for local policy-makers. To provide first-hand information on Latin American pension reforms, the World Bank and USAID also sponsored trips to Argentina and Chile for Polish and Bulgarian MPs, social security experts and journalists. The IMF and USAID took part in relevant cross-conditionalities with the Bank, as well as other forms of cooperation, but played a less outstanding role overall.

Another potent channel for the new pension orthodoxy to spread her ideas in the post-socialist world was direct learning from regional peers and role models, once precedents had been set in Central Europe. The early reforms in Hungary (1998) and Poland (1999) have triggered a regional contagion effect from the Baltics to the Balkans, comparable only to the impact of the 'Chilean model' in Latin America. There is also evidence on demonstration effects from the more radical Kazakh reform to other Central Asian countries.

***Political actors and the policy context***

While the privatization of old-age security was clearly a major policy recommendation from abroad facing any pension reformer in Central and Eastern Europe, it was the domestic political process that eventually resulted in the adoption or rejection of radical pension reform. The following analysis identifies relevant political actors in the pension reform arena and discusses their room for manoeuvre, as influenced by economic context conditions.

Scholars of the political economy of policy reform have stressed the importance of political leadership – courageous, committed individuals, often market-oriented economists – and their ability to communicate a coherent vision (Harberger 1993; Sachs 1994). Pension privatization amounts to a paradigm shift that may be greatly facilitated by such committed policy-makers famous for the radical economic reforms they pushed through, such as Bokros in Hungary. In Poland, there is unanimity that radical pension reform would have been impossible without the initial push by Andrzej Baczkowski. Michal Rutkowski and Zoran Anusic, World Bank economists on leave, played an important role in Poland and Croatia. However, the existence of such agenda-setters can certainly not be considered sufficient to guarantee success (Williamson and Haggard 1994; Tommasi and Velasco 1996). This is particularly highlighted by the Slovene case, in which Tone Rop, one of the most influential individual policy-makers, could not impose pension privatization against the Minister of Finance and the trade unions (Müller 2002a).

As to institutional actors that have been relevant in the pension reform arena, most of the above cases of pension privatization have witnessed the ministry of finance as a key player. This ministry is often staffed with neoliberally trained economists who feel that pension privatization perfectly matches their overall efforts to decrease the role of the state in the economy. The role of the minister of finance was especially pronounced in Poland, Hungary, Croatia and Estonia. This actor, for whom pension privatization was a means to achieve macroeconomic rather than social objectives, was supported by local interest groups, such as business organizations and the financial sector, as well as the IFIs.

Contrary to this, the ministries of labour or welfare, responsible for the existing old-age security schemes, were often reluctant to engage in structural pension reform, thus reflecting the existing Bismarckian traditions in Central and Eastern Europe. In Poland and Hungary, these ministries objected to the radical paradigm shift, but – given the predominance of the finance ministry in the cabinet – were too weak to prevent it. The Lithuanian Labour Ministry initially opposed the move towards mandatory prefunding, but proved impotent when the Prime Minister joined hands with the most important local ally of the new pension orthodoxy, a free-market think-tank. In Poland and Bulgaria, labour ministers that had rejected the shift to prefunding were replaced with new ones with an *ex ante* commitment to a mandatory prefunded tier, in order to facilitate the iconoclastic move. In many cases of pension privatization, the labour ministry's influence on reform design was deliberately limited by the

setting up of small task-forces that worked out the draft legislation and served to bypass the labour ministry's pension-related competences (Müller 1999; Nelson 2001). This policy pattern confirms the technocratization of decision-making and the key role of 'insulated policy-making elites' in pension privatization (Schamis 1999: 265).

In Slovenia, the ideational distinctions between both ministries proved to be less clear-cut: the Minister of Labour, an economist, was the principal advocate of partial pension privatization, but was vetoed by the unions and the Finance Ministry. Similarly, the Latvian Minister of Welfare, who had worked for private insurance companies while in exile in Australia, took the lead in promoting pension privatization in his country. A harmonious cooperation between the Minister of Labour and the new pension orthodoxy could also be observed in Bulgaria's pension privatization, where the labour minister in question had served on the managing board of a pension fund before and was thus no stranger to the financial services industry.

In many countries, social security employees, pensioners' associations and/or special interest groups with privileged pension schemes have opposed pension privatization. In the post-socialist world, trade unions have also been dubbed 'pensioners' parties' since many of their members are retired. In the Czech Republic and Slovenia plans to reform old-age security triggered the largest political rallies since independence. It is interesting to note that the Czech unions voiced strong opposition against the 1995 pension reform law, but started to advocate parametric reforms when pension privatization appeared on the political agenda. The Pensioners' Party failed to enter parliament in the Czech Republic, yet it even formed part of the governing coalition in Slovenia at the time of the 1999 parametric reform. Poland's Solidarity trade union even participated in the conceptual debate on systemic pension reform with an early proposal in support of a partial shift to prefunding. In Croatia most trade unions voiced opposition against pension privatization, except for the union of state employees, that considered setting up a second-tier pension fund. Interestingly, the retired persons' trade union also agreed with the move to prefunding. Trade unions in Bulgaria supported partial pension privatization, given their pre-existing business interests in this industry.

Left-wing parties did not always join the ranks of the opponents of a shift to prefunding either. There have been many cases where market-friendly reforms have not been carried out by conservative free marketeers, but rather by left-wing governments – a phenomenon called the 'Nixon-in-China syndrome' (Rodrik 1994). The post-socialist governments in Poland and Hungary are among the 'unlikely' administrations involved in pension privatization. It can be argued that in a context of high indebtedness, these left-wing governments were under a stronger pressure from international creditors to demonstrate their commitment to market-oriented reforms. Moreover, they were better suited to handle opposition from trade unions. In both Hungary and Poland, the governing parties had traditional ties with the unions and used them to ease resistance.

Economic factors and considerations have had a substantial impact on the

choice of the reform model. As noted above, pension privatization has been primarily proposed for macroeconomic motives, seeking to embark on a virtuous circle leading to economic growth. Moreover, scholars of the political economy of policy reform have highlighted that a preceding crisis may induce radical change – the so-called ‘benefit of crises’ hypothesis (Drazen and Grilli 1993). Crises may enable policy reform because they can change the relevant constellation of actors. In the pension reform arena, they tend to reinforce the ‘privatization faction’. Fiscal crises turn finance ministries into potential actors in the pension reform arena. More specifically, when pension finances go into the red, the resulting dependence on budgetary subsidies grant this likely advocate of the ‘new pension orthodoxy’ an important stake in reforming old-age security (Müller 1999). Furthermore, a persistent financial crisis may severely erode public confidence in the public pension systems, thus facilitating fundamental reform.

Almost all countries reviewed here experienced a sizeable fiscal deficit and/or high pension expenditure prior to reform. Croatia’s fiscal deficits were low, but public pension spending and system dependency ratios soared. Hungary and Bulgaria witnessed a grave economic crisis before embarking on pension privatization. In Bulgaria, Lithuania and Estonia, the need for fiscal restraint was heightened by the adoption of a currency board. In Latvia and Lithuania, the shortcomings of the existing social security systems – financial deficits, low replacement rates, payment arrears – plus the discredit the public schemes had earned with the unpopular flat-rate emergency benefits in the early 1990s, helped interested actors to prepare the ground for the radical paradigm shift (Müller 2005d).

There is, however, a flip side to the economic factors and considerations that potentially pushed pension privatization in many places. In the Czech Republic and Slovenia, policy-makers were fully aware that pension privatization would have resulted in substantial fiscal costs in the short and medium run, thus complicating future compliance with the Maastricht criteria. In a context of high implicit pension debt, this concern may render ministers of finance potentially ambivalent allies of the new pension orthodoxy. Moreover, while the development of the local capital market was a frequently mentioned motive for pension privatization elsewhere, policy-makers in both countries explicitly pointed to the nascent stage of Slovenia’s capital market and the crisis-ridden financial sector in the Czech Republic when cautioning against radical pension privatization. In Croatia, Bulgaria and the Baltic states, similar concerns led policy-makers to postpone – but not abandon – the introduction of the mandatory prefunded tier for several years.

Yet another economic context factor needs consideration. When external debt is high, governments tend to stress their general commitment to market-oriented reform. The announcement of pension privatization can be interpreted as a ‘signalling’ strategy (Rodrik 1998), as rating agencies include radical pension reform as a point in favour in their country-risk assessments, in spite of its fiscal impact. Critical indebtedness also increases the likelihood of the involvement of

the IFIs in the local pension reform arena (Brooks 1998). Their leverage is partly determined by their stakes as important creditors in many transition countries and partly by the general level of external indebtedness, as the IMF and the World Bank 'may signal that a developing country has embraced sound policies and hence boost its credibility' (Stiglitz 1998: 27). When their recommendations are disregarded by local governments, alternative sources of market financing are often hard to obtain.

Bulgaria and Poland were classified as severely indebted at the time of pension privatization, Hungary as moderately indebted. Latvia, Estonia and Lithuania did not inherit any external debt from the Soviet Union and remained less indebted until the late 1990s, which may explain why direct World Bank involvement was considerably weaker in the Baltic states than in most other cases of pension privatization. Croatia's indebtedness was also classified as low, but the country's political isolation under Franjo Tudjman still rendered the IFIs important international allies. In the cases of the Czech Republic and Slovenia, that are not only characterized by a low level of external debt, but have long been the most advanced transition countries, both the potential leverage and the interest of the IFIs to spend resources on the promotion of pension privatization were severely limited. Thus, the 'global politics of attention' (Orenstein 2001; Orenstein and Haas 2002) needs careful differentiation.

### ***The importance of reform design***

In several of the country cases reviewed here, reformers attached great importance to reform design, with a view of lowering the political resistance to pension reform. The relevance of tactical sequencing, strategic bundling, packaging and compensation has been stressed by scholars of the political economy of policy reform (Haggard and Webb 1993; Sturzenegger and Tommasi 1998).

The Hungarian and Polish reformers resorted to tactical packaging when they distanced themselves from the Latin American models and stressed the originality of local reform efforts (for example, Rutkowski 1998). In spite of the obvious conceptual parallels that indicate a *de facto* inclination to the Latin American models, policy-makers decided to avoid all reference to these precedents, as soon as they found out about the inconvenient connotations among the Central European public (Müller 1999; Orenstein 2000). To mitigate resistance to reform, reformers resorted to direct compensation by granting compensatory pensions to those who switched to the newly established prefunded tier, even though for fiscal reasons acquired pension entitlements were rarely recognized completely. In most countries, reformers also opted for a strategy of exclusionary compensation and division of potential opponents by exempting powerful pressure groups, such as farmers in Poland, from structural pension reform.

Full or partial pension privatization enables policy-makers to hand out potentially attractive stakes to potential opponents, thus creating constituencies (Graham 1997). 'Shifting to a funded scheme ... allows for arguments that all can win, thus abandoning intractable zero-sum games' (Holzmann 1997: 3). As



noted above, trade unions were converted into stakeholders of pension privatization in a number of countries, as reformers granted them the right to run their own pension funds. In Bulgaria, the trade unions' business interests in the private pension industry even preceded plans to establish a mandatory prefunded tier, thus facilitating a broad consensus on partial pension privatization.

Polish policy-makers intended to embark on strategic bundling by linking enterprise privatization with systemic pension reform. Similar plans existed in Latvia, but were quietly dropped from the political agenda. The Poles eventually decided to use privatization proceeds to cover transition costs by supplying them to the state budget. While helping to solve the fiscal consequences of a partial shift to prefunding, this use of privatization proceeds completely lacks visibility (Gesell-Schmidt *et al.* 1999). In Bulgaria, reformers thought that private pension funds could transform privatization vouchers into tangible benefits, but met with a lack of enthusiasm among private pension fund administrators to convert vouchers into old-age pensions.

As stressed by Pierson (1994), the political costs of reform can be lowered by increasing its complexity. In several East European countries, the reformers' strategy amounted to bundling up some unavoidable, yet politically sensitive reforms of the public PAYG tier with the more visible introduction of individual pension fund accounts (Holzmann 2000). This 'obfuscation strategy' in Pierson's terms (1994: 21) entails the potential to lower the visibility of the envisaged cutbacks and to draw public attention to the granting of individualized ownership claims. The introduction of the individual pension fund accounts tended to be perceived as the creation of a monitorable track record of individual property rights over time, that the political system would be less likely to take away. In contrast to the unfavourable public perception of parametric reforms, the drawbacks related to pension privatization are often easier to conceal (Müller 1999).

Most notably, the scope and financing of transition costs – a major fiscal and distributional issue when it comes to a shift to prefunding – was successfully shielded from public debate. Hence, the public perception of the strengths and weaknesses of pension privatization was biased towards its advantages, while the concomitant fiscal burdens were ignored. This asymmetry of perception may explain the observable fact that policy-makers have legislated structural pension reform in pre-electoral periods (for example, in Hungary, Poland), contrary to the conventional notion that retrenchment as well as radical reforms are unlikely to be tackled when the hazards of accountability are high. This suggests that the perceived attractiveness of pension privatization may outweigh its blame-generating potential, thereby differing markedly from the politico-economic potential of parametric reforms. However, the prospect of new privately-run pension funds was received less enthusiastically in countries where memories of fraudulent pyramid schemes and failing banks were fresh, such as Croatia and Bulgaria.

When it comes to sequencing, a fiscally motivated strategy was chosen in Croatia and Bulgaria, that started with a downsizing of the public scheme and introduced a prefunded tier only three years later. However, as the different components of pension reform were legislated as parts of an overall package and



by the same government, an underlying bundling strategy can still be observed. Likewise, in Latvia and Estonia three-pillar blueprints, approved by governments early on, highlighted the commitment made and the roadmap to be followed. In terms of legislating and implementing the prefunded tiers, both Baltic countries opted for a deliberate unbundling strategy. The piecemeal sequencing – with the first tier legislated first, the third tier second and the second tier last – could not derail the move towards a paradigm shift in old-age security, in spite of short-lived governments.

Polish policy-makers resorted to a mixed unbundling-bundling strategy, mainly driven by the political business cycle. Pension privatization was legislated by the outgoing government, while the restructuring of the public tier was left to the new government. Pension reform was then bundled up with three other structural reforms, that were to come into force simultaneously. The latter turned out to be a very costly strategy. Pension reform preparations, most notably the IT system, were not ready on time, but the reform ‘had to’ start anyway, resulting in substantial implementation problems that persisted for years. This example highlights that the reformers’ desire to exploit a political window of opportunity to pass and implement pension privatization may clash with optimal reform preparations and existing state capacities.

### **Concluding remarks**

Pension reformers in transition countries did not start from scratch. Rather, a more difficult task had to be tackled – the rebuilding of the existing institutional framework, largely comparable at the onset of transition. Today, the number of CEE and FSU countries that have introduced far-reaching pension reforms is significant, when compared with the difficulties facing more modest reform attempts in the West. It should be noted that the different reform paths outlined above were by no means mutually exclusive. Systemic reform was often accompanied or preceded by parametric reform. Some countries opted for both NDC and mandatory prefunding, and the reformed public and new private schemes were supplemented with voluntary prefunded tiers.

Despite their ability to radically modify existing pension arrangements, the post-socialist countries did not tackle the most pressing issue facing their pre-reform pension schemes: the dramatic erosion of coverage. In most transition countries, the different approaches to pension reform share one common feature: a deliberate move from the universalist-redistributive heritage to strongly differentiated, earnings-related benefits, with an emphasis on contributory financing. At the same time, the differences in level and scope of old-age protection in the region are widening, both within and among transition countries. Crucially, plummeting formal employment is starting to translate into sharply decreasing coverage ratios. The unemployed face high and increasing poverty risk and are unable to make provisions for their old age, as are most informal sector workers. The importance of non-contributory benefits<sup>12</sup> for the elderly, that currently play a rather marginal role in the

post-socialist world (Müller 2005b), may soon be increasing if large-scale old-age poverty is to be avoided in the future.

Hence, 16 years after the start of political and economic transformation, pension reform is still an unfinished task in most post-socialist countries. Pension reformers in the region will need to find answers beyond the large-scale move from state to market and from PAYG to prefunding that is currently taking place (Fultz 2004). Yet, it will not only depend on the chosen reform design whether the elderly in the region will fare better in the future than they do now. The economic and political context is of crucial importance. Nowadays, state capacities – especially extractive and administrative capacities – clearly differ widely throughout the region. As noted by Barr (2000: 23), ‘if government is ineffective, *any* pension scheme will be at risk’ – whether private or public, contributory or non-contributory.

## Notes

- 1 Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Hungary, Macedonia, Poland, Romania, Serbia and Montenegro (formerly FR of Yugoslavia), the Slovak Republic and Slovenia.
- 2 Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, the Kyrgyz Republic, Latvia, Lithuania, Moldova, the Russian Federation, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.
- 3 Cichon (1999: 91) aptly denominates this effect as the ‘artificial ageing of a pension scheme’.
- 4 Dividing contributions among employer and employee is largely irrelevant in economic terms, but post-socialist reformers found it important to introduce individual contributions as part of a broader agenda geared towards self-provision and insurance-type arrangements, ‘after decades of spoon-feeding’ (Kornai 1997: 1186).
- 5 This is a discretionary factor, mostly boiling down to an indexation of the virtual pension capital to the growth of the contribution base.
- 6 The World Bank started propagating this model in its well-known 1994 report (World Bank 1994) and has only recently modified its approach (Holzmann and Hinz 2005).
- 7 Although most of them are private, there is one public pension fund providing an asset guarantee. As of March 2004, its privatization was being considered (Pensions International, March 2004).
- 8 In Latvia, however, the Treasury acted as the sole asset manager for the first 1.5 years, while private asset managers were admitted only afterwards and are now competing with the Treasury’s conservative asset management.
- 9 Only in Estonia an additional 2 per cent is to be paid to second-tier accounts by those insured that opted for membership.
- 10 ‘State capture is defined as shaping the formation of the basic rules of the game (i.e. laws, rules, decrees and regulations) through illicit and non-transparent private payments to public officials’ (Hellman *et al.* 2000: 2).
- 11 For the systemic pension reforms in Latin America see Mesa-Lago (2004).
- 12 Here, the distinction between contributory and non-contributory benefits is largely based on the definition proposed by Barrientos and Lloyd-Sherlock (2002: 2) – whether payroll contributions to social insurance schemes constitute a prerequisite for entitlement, or not.

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## **Part II**

# **Reform options and outcomes**





## 6 Changing European welfare

### The new distributional principles of pension policy

*Camila Arza*<sup>1</sup>

#### Introduction

Over the past few decades, a wave of pension reform has spread across Europe. Demographic change has challenged future pension finances and pushed governments to bring the uncomfortable issue of reform to the top of the political agenda. With the explicit aim to achieve long-term financial sustainability, most European countries have embarked on a process of reform which ranged from small parametric adjustments to the radical redefinition of the pension systems set up over the twentieth century. However, the long periods of transition typical of reforms in the pension arena make it still difficult to appreciate the specific social impacts of these changes. While projections indicate that most reforms have improved the financial prospects of European pension schemes, mainly by reducing the growth of public pension expenditures, the distributional effects of these financial adjustments remain largely unknown.

This chapter studies the distributional principles of pension reform in four European countries by focusing on the specific regulatory changes and their expected impacts on the distribution of pension rights, pension resources and the risks of old-age financing. It argues that pension reform in Europe has set out a pathway towards ‘individualised’ systems of old-age protection which are characterised by reproducing income and labour market inequalities upon retirement. The actual distributional impacts of these reforms will therefore depend more closely on the evolution and distribution of individual characteristics and, in particular, on individual labour market histories. The individualisation of pension entitlements has not only (or not necessarily) been done by privatising retirement systems, a process which in Western Europe has been more limited than elsewhere (e.g. Latin America, Central and Eastern Europe). It has also been done with a number of institutional adjustments that have tended to make benefits increasingly conditional on means-tests (i.e. individual income/wealth situation) and/or contributory history (i.e. individual wage, work type, compliance, choices), and to simultaneously reduce the pooling of old-age risks which were largely transferred to the individual. Institutionally, this implied increasing the share of private provision in overall pension policy (and the share of funded defined-contribution (DC) arrangements within the existing private

sector), and/or redesigning public provision in a way that enforces the actuarial logic of the system, mimicking private DC arrangements (via notional defined contribution (NDC) models). As public pensions went through cost-containment reforms that reduced replacement rates for the future, the public-private mix tended to rebalance towards the private sector.

The empirical analysis is based on four case studies: Italy, Sweden, Poland and the UK. The choice of cases was based on two criteria: their originally different pension arrangements (which aimed to comprise the wide spectrum of 'pension regimes'), and the application, in all four cases, of significant pension reforms, which have tended to reshape existing pension structures over the past two decades. The pathway towards a common broadly-conceived set of principles for the distribution of rights, resources and risks is found in reforms implemented in all four countries from the 1990s onwards, with the exception of the UK, where the process commenced a decade before. The second section lays out the reform process in each of the four cases, and the third section analyses the distributional nature of these reforms and evaluates the scope for extending the argument to the wider European context. Finally, some considerations on the eventual explanatory factors for these reform trajectories are advanced in the conclusion.

## **European pension reform in a four-case study**

### ***The case of Italy***

The Italian pension scheme has always been typically Bismarckian, with benefits allocated according to workers' position in the occupational structure and designed to preserve status differentials between occupational groups. Earnings-related benefits were exclusively provided by the state, leaving virtually no role to the market in welfare provision. In practice, this resulted in a particularistic system, with a segmented benefit structure, high benefit levels and easy-to-meet eligibility conditions for privileged workers. Private pensions were virtually inexistent, representing only 2 per cent of total pensions receipts in 1980.<sup>2</sup> Eligibility conditions and replacement rates often varied across occupational groups, reflecting status differences and producing a fairly unequal distribution in cross-section: two workers with similar wages and employment histories could get different rates of return to lifetime contributions simply because they belonged to economic sectors under different pension rules. Within occupational groups, however, intra-generational redistribution of pension resources was common via the application of progressive benefit formulas.

Over the 1990s, the Italian pension system entered a major process of reform that would redefine the structure of old-age income protection. Both the 'Amato reform' in 1992 and the 'Dini reform' in 1995 were explicitly directed to contain the future growth of public pension expenditures. In the early 1990s, Italy had very pressing demographic prospects. As a result of increasing life expectancy and sharply declining fertility rates, the old-age dependency ratio was among the

highest in Europe.<sup>3</sup> Demographic dynamics, combined with low labour market participation and a generous pension system, resulted in expenditure forecasts difficult to sustain. Projections made in the 1980s by the OECD estimated an increase in the costs of pension financing of over 16 points of GDP between 1984 and 2050 (from 16.9 to 33 per cent of GDP) (OECD 1988). Reforms in the 1990s aimed at tackling these expenditure prospects. In any PAYG system, financial equilibrium is determined by the relation between the size of the working population (given by demographic and labour market patterns), the level of taxable wages and contribution rates, on the one hand, and the size of the retired population and the level of benefits, on the other.<sup>4</sup> All these aspects can, in one way or the other, be modified by government action. Amato's reform was a purely cost-containment type of reform which aimed to reduce in the short and middle term both the size of the retired population (by tightening eligibility conditions) and the value of pension benefit entitlements (by modifying the basis for benefit calculation and indexation) (see e.g. Brugiavini 2000). It increased retirement ages and the number of contribution years required for standard and early retirement,<sup>5</sup> extended the reference wage for benefit calculation to workers' entire careers,<sup>6</sup> and changed the rule for benefit indexation from earnings to prices. This both encouraged workers to stay longer in the labour market (thus shrinking the size of the retired population) and simultaneously reduced the future value of benefit commitments.

The Dini reform in 1995 also included some parametric adjustments along with a systematic change in the distribution of benefit entitlements. The whole benefit calculation mechanism was redefined, converting a defined-benefit (DB) earnings-related scheme into a system that made the value of benefit entitlements dependent on individual contributions, under a NDC model. In the new system, pension benefits are calculated by applying an annuity coefficient of residual life expectancy upon retirement to the 'notional' pension assets accumulated over each individual's working life. The thrust of the Dini reform was to establish a system of equivalence between individual contributions and benefits which could restrict the growth of public pension expenditures in the future, while simultaneously allowing for greater flexibility in retirement decisions. Workers were allowed to retire between 57 and 65 years old and with only five years of contributions, but their benefit levels would be reduced accordingly.<sup>7</sup> While the pension system prior to 1995 was based on a progressive earnings-related benefit formula<sup>8</sup> which provided higher relative-to-wages benefits to low income groups, the new system produces no redistribution between income brackets: entitlements were individualised and strictly linked to contributions made by each worker over his or her working life. Redistribution is instead left to a non-contributory and residual leg of the system, where the *Assegno Sociale*, a non-contributory benefit granted under strict means-testing is created to replace the minimum benefit previously existing in the contributory system (*Pensione Sociale*). Therefore means-tested benefits, which were previously directed only to workers who could not meet the eligibility conditions to claim for contributory social insurance, were extended to both covered and uncovered

workers as the non-contributory poverty-prevention leg of the system guaranteed by the state.

Simultaneously, incentives were introduced to shift some of the old-age income protection to the private sector. Additional savings into private accounts were regarded as a tool to compensate for the projected fall in public pensions. Given the high replacement rates and wide coverage of public pensions, private schemes never really developed in Italy. There was also hardly any regulation for the operation of private pensions until the 1990s. A bill passed in 1993,<sup>9</sup> created voluntary complementary pensions to be organised on individual or occupational basis, and started to shape the Italian voluntary system. This was the beginning of an incremental process of increasing incentives to promote private pension savings. Voluntary contributions to either 'closed' pension fund for workers in particular industries or firms, or 'open' pension funds managed by insurance companies and banks, were made tax-deductible up to a threshold. The Dini reform also established an earnings ceiling to participate in the public system – high income groups could thus reorient contributions on wages above this ceiling to private accounts. In 2000 another bill<sup>10</sup> introduced individual pension funds and life insurance policies as part of the voluntary pillar created in 1993. In 2004, parliament approved a bill boosting private pensions further. It established that contributions allocated to a severance pay<sup>11</sup> would be automatically transferred to private pension funds, except when the worker explicitly refuses.<sup>12</sup> This marked the beginning of a process of private pension development in Italy. The number of pension funds started to grow and affiliation increased. In 1992 there existed 774 pension funds (called 'pre-existent funds'); by 2004 there were an additional 134 funds, with 1.45 million affiliates.<sup>13</sup>

The impacts of this reform process on the retired population will not be observed until after the transition period is completed. Official projections rely on the development of the private sector, which is expected to replace over 16 per cent of workers wages in 2050 (Table 6.1). Even if these projections hold (which will depend on the performance of private pension funds and the expansion of 'voluntary' contributions), there continues to be a reduction in total benefit levels.<sup>14</sup> This benefit drop is particularly marked among the self-employed whose replacement rate falls from 64 to 46 per cent of earnings, as a result of their lower contribution rate (20 per cent compared to 33 per cent for employees).<sup>15</sup> The specific distributional impacts on workers with different career histories and income groups is still an issue of concern.

### *The case of Sweden*

In contrast with Italy, old-age pensions in Sweden have always been largely standardised and provided by the state to the entire resident population, eradicating both status privileges and markets from the allocation of welfare. Occupational pensions, resulting from contractual agreements between social partners, have also been significant for a long time, providing a top-up on state pensions.

Table 6.1 Italy: projected old-age pension replacement rates (first year benefit over last year wage)

	2000			2020			2030			2050		
	Public pension	Private pension	Total	Public pension	Private pension	Total	Public pension	Private pension	Total	Public pension	Private pension	Total
Private employees	67.3	0.0	67.3	56.0	9.4	65.4	49.6	14.5	64.1	48.1	16.7	64.8
Public employees	68.6	0.0	68.6	58.9	9.4	68.3	49.6	14.5	64.1	48.1	16.7	64.8
Self-employed	64.4	0.0	64.4	41.2	9.4	50.6	30.7	14.5	45.2	29.2	16.7	45.9

Source: European Commission (2002).

Note

Replacement rates are gross of taxes. Calculations assume a career length of 35 years and retirement at 60 years old.

Social partners, however, tended to be excluded from the administration of the public scheme. The Swedish system was also different from other systems of flat-rate benefits like the British. The rule of access to the Swedish flat-rate pension (the *folkpension*) was residence and not contribution years (thus providing equal benefits to workers with different career histories), and the benefit level was higher (a flat-rate pension of around 46 per cent of average wages in Sweden compared to 15–20 per cent in the UK).<sup>16</sup> The size and relevance of occupational pension benefits in overall pension income also differed (with roughly a 10 per cent replacement rate in Sweden and 23 per cent in the UK).<sup>17</sup>

The history of the *folkpension*, for a long time the cornerstone of the Swedish pension system, goes back to the beginning of the century. It was created in 1913 as a flat-rate pension benefit originally provided after a means-test. A reform in 1948 removed means-testing and consolidated the *folkpension* as a truly universal benefit covering all the resident population in the country (Olsson 1987). In 1959 an earnings-related supplement (*allmän tilläggspension* – ATP) was created, moving the overall old-age protection system somewhat towards the Bismarckian model (Hinrichs 2001). However, the creation of a contributory earnings-related layer did not erode the universalistic basis of the system. The *folkpension* continued to provide coverage to the entire population, while more comprehensive income-replacement made the pension system increasingly important for the middle classes. In 1969, a formal link between the *folkpension* and ATP was made with the creation of a pension supplement for pensioners with no or low ATP pensions. The value of the supplement was lower the higher the value of the earnings-related benefit, thus increasing final pension benefits for workers with no or short contributory histories.

Over the 1990s, Sweden went through probably the most substantial processes of reform in Western Europe, transforming most of its public and occupational pensions (in separate processes) from DB to DC. After some years of deliberation and negotiation, the public pension reform bill was passed in two steps between 1994 and 1999 (see e.g. Palmer 2000). The *garantipension* (GP) replaced the *folkpension*, which was eliminated.<sup>18</sup> Unlike the *folkpension* which was flat-rate, universal and largely financed by employer contributions, the GP is non-contributory (financed with tax revenues), and transfer-tested against other pension receipts: its value depends on the value of other statutory pension benefits (the higher ‘other benefits’, the lower the GP). In addition, the existing earnings-related scheme (ATP) was replaced with the *inkomstpension* (IP), a NDC benefit, and topped up by the *premiepension* (PP), a system of mandatory, funded and state-administered individual pension accounts, which receives 2.5 per cent of workers’ wages.

Non-statutory occupational pensions originating in nationwide agreements between employers and trade unions played a relatively important role in Sweden, both before and after the creation and expansion of state benefits (see e.g. Overbye 1998). Almost simultaneously to the reforms in statutory pension system, there were significant changes introduced in non-statutory occupa-

Table 6.2 Sweden: projected old-age pension replacement rates (first year benefit over last year wage)

	2003	2010	2030	2050
Gross RR statutory pensions (including PP)	57.0	49.7	42.7	40.1
Gross RR occupational pensions	13.9	14.2	14.5	14.2
Total gross RR	70.9	63.8	57.2	54.4
Total net RR	74.6	67.2	59.3	55.7

Source: European Commission (2004).

Note

Calculations assume flat earnings profile, career length of 40 years and retirement at 65 years old.

RR = replacement

tional pensions. In 1998, the pension scheme for blue-collar workers started to move in the same direction of the statutory system, from a DB to a DC model (Palmer and Wadensjö 2004). The scheme for local government personnel followed in 2000, and that for state workers in 2002. In these three cases, contributions of between 3 and 4.3 per cent of wages are paid into individual funded accounts. Local and central government schemes maintain some DB entitlements for earnings above the public scheme earnings threshold. Although replacement rates provided by occupational pensions are estimated to increase slightly over the next 50 years, the sharp reduction of public pensions projected after the reform produces an overall fall in (gross) total replacement rates, from 70.9 per cent in 2003, down to 54.4 per cent in 2050 (see Table 6.2). In Sweden as in Italy, pension reform balanced pension finances at the cost of cutting future benefit entitlements. While these figures suggest that inter-generational impacts of reform must have been strong (younger generations receiving lower income replacement than older generation, who retired under previous pension rules), they hide the new distribution of benefits within cohorts that can emerge with the shift from a flat-rate DB to an actuarial DC system.

### *The case of Poland*

Unlike in Italy and Sweden, pension reform in Poland was embedded into a wider process of political and economic restructuring of a transition economy, shared across Central and Eastern European (CEE) and former Soviet Union (FSU) countries. Horstmann and Schmähl (2002) identify three stages in pension reform in CEE. First, from 1989 to 1992, there was a period of reactive transformation in response to changes in the economic and political system which typically included better indexation mechanisms, the extension of pension coverage to the self-employed, and the abolition of most of privileges of existing pension systems. A second period (1992–1996) was characterised by the reform of pension formulas and the concession of greater financial independence for pension schemes. The third period started in 1996 and was the phase

where not only the instruments but also the objectives of pension policy started to change: the period of structural reform.

In the early 1990s, the Polish pension system inherited from the socialist years was a fully public system administered on PAYG basis. It had been created somewhat later than in Western Europe (in 1927–1933), and was always characterised by a great deal of particularism in eligibility conditions, with some occupational groups getting easier access to benefits (like workers in dangerous work, but also those considered strategic for the economic policy of the period). Over the first few years of transition, some particularism was abolished, eligibility conditions and entitlements were largely standardised, and the administration of resources was detached from the general budget (Golinowska and Zukowski 2002). Special schemes, however, continued to exist even after the 1999 reform, for the armed forces, police, judges and prosecutors, and farmers (who have a separate administrative body) (ZUS 2004).<sup>19</sup> Before the reform, the benefit structure was earnings-related but the benefit calculation formula included a basic flat-rate component which tended to make relative-to-wages benefits higher for low-wage workers,<sup>20</sup> thus weakening the link between contributions and benefits (Fultz and Ruck 2001). Although the system was originally funded, it converted to PAYG in the post-Second World War after resources depleted. During the socialist period worker contributions were abolished and benefits were financed by employer contributions (i.e. state transfers) only. Statutory retirement ages were somewhat below those in OECD countries, and there were many alternatives for early retirement. As the effective retirement age was quite low, the system matured faster. The sharp increase in unemployment brought about by the transition affected financial equilibria: aggregate receipts from contributions fell, and the use of early retirement as a sort of unemployment benefit dramatically increased payouts.<sup>21</sup>

Poland did not simply adopt the parametric adjustments typical to other countries. Instead, it opted for a radical revision of the organisational structure and the basic principles underpinning the retirement system. Closely influenced by the World Bank prescriptions on ‘best practice’ contained in *Averting the old age crisis* (World Bank 1994), Poland, as other CEE and Latin American countries, transformed the existing social insurance system into a three-pillar model (Müller 1999, 2002; Golinowska 1999), which included private administration and pension funding. The substitution of private for public administration was however not complete and the state maintains a role in income-replacement alongside the newly introduced private pension funds, in what was called a ‘mixed’ pension system (see e.g. Fultz 2003; Putelbergier 2000; Müller 2002, 2003; Chlon-Dominczak 2004). A first state-managed pillar continues to operate on PAYG basis but moves from a DB to a NDC model. A second pillar of privately administered fully-funded individual accounts is introduced as an integral part of the statutory pension system. The third pillar, made of voluntary additional savings, remains largely underdeveloped. Such a radical change both in the institutional structure and the public-private mix in pension administration, has no parallel in Western Europe. Institutional constraints and high transition



costs, which elsewhere tended to restrict the scope for structural shifts from PAYG to funding, and from public to private administration, did not prevent radical reform in Poland. The pension system was deeply rooted in the social structure: it had been in operation for a long time, provided almost universal coverage and had accumulated entitlements with currently working population which made the transition long and costly. The fact that reform could actually take place makes Poland an interesting case for students of institutional change to evaluate the conditions under which institutional resilience can be overcome or counterbalanced by other eventually stronger forces pushing for reform.<sup>22</sup> The overall process of transition, economic restructuring and crisis, seems to offer at least some hints on the reasons why this type of reform was politically possible here and not elsewhere (see also Chapter 5 in this volume).

### *The case of the UK*

The history of public pensions in the UK starts with the 1908 Pension Act, which created a means-tested non-contributory old-age benefit. From then on, public pension policy developed incrementally, adding new layers to the existing system, rather than replacing it with a new one, like in the Polish case. A reform in 1925 introduced the contributory principle in a pension scheme of flat-rate contributions and benefits. A significant move towards comprehensive social insurance occurred in the 1940s, after the influential Beveridge Report (Beveridge 1942). The 1946 Social Insurance Act established a universal contributory pension scheme with flat-rate benefits. The Basic State Pension (BSP) became the cornerstone of British old-age income security, providing flat and low benefits, of between 19.6 per cent of average earnings in 1982 to 15.2 per cent in 1995 (Emmerson and Johnson 2001: 301). As eligibility was based on contributory history, the BSP could not guarantee poverty prevention in cases of short or discontinuous working histories (especially relevant for the case of women), and was supplemented by means-tested social assistance for individuals whose contributory history was not sufficient to get a full BSP entitlement.

Supplementary pensions were widely provided by private companies. The UK has a long-standing tradition of occupational pensions which contribute to a significant share of pensioner's income. Since the BSP was always low it did not 'crowd out' private provision. Over the 1940s and 1950s, occupational schemes continued to develop, providing top-up pensions for workers in the best occupational positions, and covering roughly half of the working population since 1960 (Emmerson and Johnson 2001). A divide between privileged and unprivileged workers became evident: workers with occupational pension coverage could obtain higher benefits than workers who relied solely on the BSP. This encouraged the creation of an earnings-related layer in the public pension system. In 1959, the first earnings-related component was set up. A few decades after the State Earnings Related Pension Scheme (SERPS) was created (implemented in 1978), establishing a fully-indexed benefit equivalent to 25 per cent of earnings on top of the BSP (Pampel and Williamson 1993). In order not to 'crowd out'

private provision, workers with occupational pensions were allowed to 'contract-out' of the SERPS in exchange for rebates on their national insurance contributions. 'Contracted-out' workers would receive the flat-rate BSP plus the occupational earnings-related pension benefit.<sup>23</sup>

A substantial process of reform of the pension system started in the early 1980s, in the context of welfare retrenchment under Thatcher administration,<sup>24</sup> that is, well before other European countries, and quite before the financial sustainability of pension schemes was really in danger.<sup>25</sup> Within a set of wider policies to reduce the economic role of the state and give more room to the private sector, a succession of incremental modifications altered the public-private mix by reducing the scope of public provision and channelling welfare expansion towards the private sector. Public pension commitments were restricted in three main ways. First, the 1980 Social Security Act modified the indexing mechanism: the BSP started to follow prices rather than earnings which, in a context of growing real earnings, produced a reduction of the relative value of benefits. Second, the 1986 Social Security Act cut the value of the SERPS from 25 to 20 per cent of past earnings, halved widow's pensions, and changed the base-wage on which benefits were calculated from the best 20 years to the entire working life. In fact, a government proposal for reform in 1985 aimed to completely eliminate the SERPS and introduce minimum mandatory contributions to occupational or private pensions. Political opposition from different angles blocked the passage of the reform and in 1986 the phased reduction of SERPS entitlements was adopted as a compromise (Pierson 1994). Private alternatives to the SERPS continued to be encouraged with additional contribution rebates for workers contracting out to personal pensions. A third mechanism to reduce pension provision was also adopted in 1986, when workers were given the option to opt out of the SERPS as well as of the occupational pension to join a DC personal pension plan instead. The state would deposit a rebate from national insurance contributions in personal accounts and individuals could make additional voluntary contributions which were tax-free up to a certain threshold. This contributed to increase the role of individual DC pension arrangements in overall pension policy, extending private pension coverage even for workers in companies that did not provide occupational pensions. The 1986 Social Security Act was the first major move towards individualised pension arrangements, which in the UK, unlike Sweden and Italy, was fully based on a shift towards the private sector and, unlike Poland, was guided by incentives rather than compulsion. Individualised pension policy did not result solely from the privatisation of pension coverage, but from the concomitant change of private pension arrangements from DB to DC: the 1986 Social Security Act also allowed employers to convert their occupational pensions (which were mostly DB plans) into DC, as some did in the following years (Liu 1999).

This trend towards the individualisation of pension entitlements and the increased participation of private pension alternatives in overall pension policy was not reversed under the Labour government, although some adjustments were also made to guarantee better coverage for workers with short and

discontinuous working careers. In the past few years, the extension of private pension coverage was targeted to workers in the lower income brackets, who tended to be excluded from occupational and personal pensions. This guided the creation in 2001 of a low cost personal pension scheme, the Stakeholder Pension (SP) which, however, did not really succeed in attracting voluntary savings from low income groups. Simultaneously the SERPS was converted into the new State Second Pension (S2P), which has a fairly flat distribution at the bottom, and provides higher entitlements than the SERPS for workers with low income and short working careers. As both the SERPS (earnings-related), and the BSP (flat-rate) depend on the number of contribution years, workers with short contributory histories were particularly at risk. The S2P increased the replacement rate of low income earners, and partly compensated for the negative impact of working careers on future benefit entitlements, while simultaneously recognising credits for people out of the labour market under specific state allowances (such as child benefit, carers' allowance, disability allowance, and so forth). The progressive benefit formula of the S2P however, strongly encourages middle and high income groups to contract out, further limiting the state's role in pension provision to the bottom of the income distribution. In addition, as a result of price-indexation, the BSP has continuously fallen in relation to mean earnings. State pensions thus tended to move back the residual role they had at the beginning of the twentieth century, providing low benefits for the poor, and increasingly relying on means-testing. In 1999, a new means-tested benefit (Minimum Income Guarantee (MIG)) was created by modifying already existing income support premiums paid to pensioners. As the level of the MIG was set to rise with earnings, it was expected to grow relatively more than the BSP (which is indexed to prices) thus increasing the number of pensioners eligible for means-tested benefits. The disincentives for individual savings entailed by a means-tested benefit like the MIG were against the overall policy of encouraging voluntary contributions to personal pensions. This made the government finally introduce, in 2003, the Pension Credit (PC), which is not a fully means-tested benefit but also provides (reduced) benefits for workers with some pension savings.

Overall, this incremental process of reform produced three clearly observable effects. First, a decline in prospective replacement rates in the public pillar, which have been estimated to fall from an already low 16.6 per cent in 2002 to only 11 per cent in 2050. As private second pillar pensions (occupational and personal) were projected to provide a constant replacement rate of 50 per cent of earnings, the overall replacement rate falls over five percentage points over the 2002–2050 period (Table 6.3). Second, the reform process produced a remarkable rise in the proportion of workers with private as opposed to public income-replacement pensions. While from the creation of the SERPS up to the mid-1980s, there was a roughly 50/50 distribution of workers between public and private alternatives, after the 1986 Social Security Act, the percentage of workers with private pensions rose from 47 per cent in 1985/1986, to a peak of 69 per cent in 1992/1993, after which it fell to 58 per cent in 2001/2002,<sup>26</sup>

*Table 6.3* United Kingdom: projected old-age pension replacement rates (first year benefit over last year wage)

	2002	2010	2030	2050
Gross RR public pensions (BSP, SERPS, S2P)	16.6	16.1	13.9	11.4
Gross RR private and occupational pensions	50.0	50.0	50.0	50.0
Total gross RR	66.6	66.1	63.9	61.4
Total net RR	81.9	81.4	78.9	76.2

Source: European Commission (2004).

Note

Calculations assume flat earnings profile, career length of 40 years and retirement at 65 years old.

RR = replacement

probably as a result of the personal pension mis-selling scandal and the increasing reluctance of employers to provide occupational pensions. Finally within private pension arrangements, there is a marked shift from DB to DC schemes, which is led by the increased importance of personal pensions. In 1978/1979, virtually all private (occupational) pension schemes were DB. By 1987/1988, after the 1986 Social Security Act encouraged the adoption of personal pension plans and authorised the conversion of occupational schemes from DB to DC, it was estimated that 27 per cent of private pension plans were DC. By 2001/2002 this figure had risen to 43 per cent, with the remaining 55 per cent of private schemes under DB plans, and 2 per cent under mixed systems.<sup>27</sup>

### **The new distributional principles of pension policy in Europe**

Pension systems are publicly organised (or regulated) institutional devices set up to distribute rights, resources and risks across the population. The distributional criteria embodied in the design of pension schemes in each national and historical context can be taken to characterise the underlying distributional aims and principles of the system. Across the history of European pension policy, countries have organised pension arrangements following varying models of stratification. The path-breaking analysis of welfare regimes by Esping-Andersen (1990), as well as other significant contributions in this direction (Ferrera 1996; Kwon 1997, among others) have indeed been oriented to capture this diversity in the distributional principles underpinning welfare (including pension) policy design. As the case studies presented in the previous section have shown, reforms undertaken over the past few decades have significantly changed the shape of existing pension arrangements. In so doing, they have often simultaneously modified the distributional logic of the system. While, given the long transition periods for reforms to actually take place, the impacts of this new distribution pattern are not yet visible, the analysis of the institutional changes introduced can help understand the distributional direction of the new pension design.

Across countries, economic challenges to pension financing were a key driving force for pension reform. The response was often also economic-based,

and relied on an individualisation of pension entitlements which could introduce the right incentives to avoid some of the key 'evils' for pension financing: early retirement, low labour market participation and the increasing financing burden levied on working populations. By making individual benefits more closely linked to individual contributions, the model of reform broadly adopted across the four case studies aimed to tackle these problems: to increase labour market participation, to reduce the incentives for early retirement and to simultaneously make (at least in theory) each generation bear its own financing burden. But in the process of tightening the link between contributions and benefits at the individual level, the pension system has become closer to a saving scheme and its redistributive functions have been reduced. Pension benefits started to be determined on an individual basis, according to contributions made, labour market histories, and in some cases also the performance of pension funds individually chosen. This individualisation of pension entitlements underpinned a paradigm shift in pension policy which has tended to focus on actuarial fairness, reduce intra- and inter-generational resource transfers, and stress financial rather than benefit stability (see also Arza 2006).

Reinforcing the actuarial logic in the distribution of benefits was also probably the most 'politically viable' way to maintain financial stability in a context where retirement ages and other eligibility conditions are difficult to change. Cutting replacement rates in a DB system is a very controversial political move. Instead, the adjustment was done, in Italy, Sweden, Poland and the UK, by reorienting the system from public to private pensions, and from DB to DC models. Benefits tend to be increasingly determined actuarially, for a given notional or financial amount of resources accumulated by each individual, following life expectancy projections. In Italy, pension reform has transformed a largely fragmented and generous retirement system with defined earnings-related benefits financed on PAYG basis, into a DC system. This was achieved with both the creation of NDC pensions and the introduction of increasing incentives for the development of voluntary private pensions operating on funded (DC) models. The same type of shift was fostered in Sweden with the creation of the IP and PP to replace the *folkpension*, and in Poland, with the conversion of the earnings-related DB system into a three-pillar model. In these three cases, benefits in the public system are increasingly determined by individual working and contributory histories and life expectancy, which tends to reduce both intra- and inter-generational income transfers. In the UK the process was somewhat different. Ironically, in the UK, where public pension expenditure prospects were the lowest in Europe, cost-containment reforms started earlier than elsewhere. The shift towards an individualised pattern of distribution of pension rights and resources was already visible in the late 1980s,<sup>28</sup> and consisted largely in a shift towards the private sector rather than the conversion of public pensions in DC systems. In fact, public pensions tended to become flatter in the contributory system and means-tested in the non-contributory one.

Across countries a greater role for the private sector reinforces the trend towards actuarial benefits and the shift of the risk of pension financing to the

individual. In Italy, private pension development was left to the voluntary sector, although the automatic inclusion of mandatory TFR contributions into private pension funds may change the picture in the close future. In Sweden a more radical decision was adopted to transfer part of workers' contributions to funded pension accounts. Although this remains a small share of total contributions, it marks a significant step towards the introduction of funded pensions within the statutory pension system. In Poland the shift was the most radical: not only were private pension accounts set up as part of the statutory system, they also received a significant share of workers' contributions, in a system that replaced (with the consequent transition costs) the previously existing fully PAYG earnings-related system. In the UK, the incremental reform process that had started in the early 1980s, was indeed based on the shift of income-replacement pension provision from the state to the individual (Disney *et al.* 2001: 1), mainly operated by the privatisation of pension coverage. Unlike the Polish case where radical change was applied in only a few years, the UK is indeed a case incremental reform. In the process of adding new layers to the existing system, pension arrangements became increasingly complex, an issue which acquires greater relevance in a context in which personal decisions (e.g. opting-out) have become more important.<sup>29</sup>

The contributory pension system (both public and private) more closely assimilates to a system of individual savings. Some of the risks of old-age financing, previously pooled across and within generations, are transferred back to the individual (Arza 2006). In DC systems, being either notional or funded, the individual bears the labour market risk (i.e. the risk of having a career history that produces low benefit entitlements). As the final value of benefits is calculated by applying a life expectancy coefficient on accumulated contributions, the risk of cohort longevity is also borne by the individual (rather than by the working population).<sup>30</sup> After the annuity is calculated, benefits are usually adjusted periodically following the growth in nominal wages or GDP growth, depending on the country. If the real value of wages or GDP fall, this may result in a reduction in the real value of pension benefits (in other words, the risk of inflation may be borne by the individual). Being PAYG, NDC systems do not guarantee financial stability, for instance, in the context of changes in labour market participation or contribution compliance (Chichon 1999). In Sweden this problem was addressed by the creation of a 'buffer fund' and an 'automatic balancing mechanism'. The buffer fund is allowed to fluctuate according to contribution receipts and benefit pay-outs and thus stabilise the finances of the system even in the context of fluctuations in labour market and demographic variables (e.g. the relative size of cohorts). This fund should also guarantee that there are no net transfers between generations – larger sized cohorts will make the fund increase during their working years, and decrease upon retirement, but the real return obtained from contributions should be similar across cohorts. If resources in the buffer fund are not sufficient to balance the NDC system, the automatic balancing mechanism is put into motion, consisting largely on the sharing of additional costs between workers and pensioners (Settergren 2001).

The reduction of risk pooling is particularly salient in the individual funded accounts that have been introduced or expanded in all four countries. These make benefit entitlements directly dependent on individual contributions (thus career and wage patterns) and the financial returns on accumulated funds. Individuals thus bear not only the risk of their own labour history, but also the financial market risk, and the risk of inflation after retirement, to varying extents depending on the regulatory framework for the calculation of annuities.<sup>31</sup> So while the individualisation of pension entitlements can help to reduce 'perverse' intra-generational transfers, moral hazard, and the incidence of particularistic distribution of privileges, it may leave some individuals to bear a greater risk burden, specially in terms of labour market risks. While pension formulas that consider only the value of wages of the last few years before retirement (as broadly existing in Europe before reforms) benefit workers with dynamic working careers (i.e. those with higher rates of lifetime wage growth), pension formulas based on the value of contributions paid throughout the working life tend to reproduce the inequalities in career patterns upon retirement. Workers with low wages and discontinuous labour market histories (women, informal workers, unemployed) are likely to be the most affected by the reduction of intra-generational risk-pooling and the elimination of the progressive redistribution embedded in the previous benefit formula in some countries (except when this is compensated with adequate pension credits).

In the new systems, high-risk groups are to be covered by the non-contributory system which is the layer of pension policy which maintains a large degree of redistribution and risk-pooling at the very bottom. In all four countries, reforms included a separation of the income-replacement from the poverty-prevention function of pension policy. Intra-generational redistribution and risk-pooling were simultaneously reduced in the first (contributory layer), and concentrated in the second (non-contributory layer). While this separation contributes to make redistribution 'explicit' and thus more transparent, it risks suffering the drawbacks of means-tested benefits: poverty traps, moral hazard and social stigma. The elimination of minimum benefits was common across countries: in Italy and Poland, existing minimum benefits were replaced by means-tested benefits. In the UK, the overlapping of different benefits makes the assessment more complex. The flat-rate BSP was maintained with a low and declining benefit level, and complemented with the S2P for workers with some contribution years. As the value of DB is reduced, means-tested benefits have a more significant role for workers with low incomes and very short contributory histories. In Sweden, the guaranteed pension which replaces for the universal flat-rate *folkpension* is transfer-tested, and in fact operates as a minimum benefit. This, together with a number of additional 'guarantees' in the contributory system,<sup>32</sup> tend to somewhat differentiate the Swedish pension system from other structural reformers.

In short, the shift from DB to DC in all pillars, has reorganised the distributional principles of the pension systems in our four case studies, moving towards a model of actuarial equivalence between individual contributions and benefits.



Redistribution via pension policy was largely abandoned in the contributory system, and reform has reoriented pension policy towards a system of individualised benefits. Intra-generational redistribution was restricted to the non-contributory system, and financed by the entire population via general taxation. Inter-generational transfers were also largely eliminated. The four countries studied here are a group of major reformers where institutional change has been more marked. Some elements of this shift towards a new distributional logic can also be observed in a number of other European countries. Alternative versions of the three-pillar model were adopted in many CEE and FSU countries (Bulgaria, Hungary, Poland, Croatia, Latvia and Estonia), where mandatory fully-funded individual accounts were set up to replace, at least partially, previously state provided earnings-related pensions. In Western Europe (apart from Sweden), Denmark has also introduced fully-funded individual accounts in the mandatory system.<sup>33</sup> Most reforms, however, have remained within existing institutional structures, and have operated either by gradually making some layers of the overall pension system more relevant than others, by adjusting eligibility or benefit rules in existing schemes, or by encouraging the development of complementary schemes in the voluntary system.<sup>34</sup> These gradual changes can modify the distributional impacts of pension policy, and its prospective outcomes, incrementally in the long term, without drastically changing current institutional structures. Three types of adjustments are common. On the one hand, a gradual shift to the private sector was fostered by introducing public incentives (such as tax exemptions) for personal savings (the UK, Austria, Italy, Portugal, among others). On the other hand, income-testing and means-testing became more important in some countries as the side-effect of tightening eligibility conditions to access benefits in the contributory system, a practice that has taken place almost everywhere in Europe. Finally, some countries transformed the benefit calculation formula in their PAYG and publicly administered earnings-related scheme into a NDC model, while others introduced life expectancy coefficients (Germany, Austria), or other parametric adjustments (e.g. changing the mechanism for benefit calculation or indexation), which tended to make benefit entitlements more closely reflect lifetime contributions. As the future value of public pension benefits falls, greater incentives are introduced to direct voluntary pension savings to the private sector.

## **Conclusion**

To different degrees depending on the country, pension reform in Europe has consolidated the principle of actuarial equity, in a pension system that reorganises the distribution of rights and resources, and makes pension benefits closely reflect individually made contributions. Social security continues to be an insurance device, but the coverage of risk is reduced and the burden is levied in a different way between individuals and the state, and across generations. The increasing adoption of DC models across Europe has tended to reinforce an actuarial type of equality, converting wage-earners into 'savers' (Bonoli and



Palier 2000). Pension systems moved towards a multi-pillar model (Bonoli 2003: 414), and the public-private mix rebalanced towards the private sector. But the shift did not only entail a 'privatisation' of pension provision. Countries have also reformed their public pension rules to mimic the pattern of distribution typically produced by private pensions. Therefore, even while maintaining some aspects of existing institutional structures that are shaped and constrained by original developments (e.g. PAYG financing), similar traces can be observed in the distributional principles underpinning pension reform in the countries studied.

From an economic point of view, the origins of the process of reform have been largely acknowledged: population ageing, changing labour market structures and the stronger pressures on public budgets and labour costs coming from the processes of globalisation and European integration, made all European governments without exception consider reforming their public pension systems. However, the need of reform does not necessarily explain the nature of the reform model chosen. Further research in the politics and ideologies of policy-making (and the mechanisms by which ideas and attitudes are formed and translated into policies) can shed some light on the reasons why this new distributional logic was adopted.<sup>35</sup>

Explanations stressing not only the economic but also the political basis of this paradigm shift seem promising. The economist's explanation stresses on the need of reform to prevent imbalances in pension finances and the negative macroeconomic impacts of increasing budgetary demands by the pension system. Cutting pension expenditures in this context largely meant reducing future benefit commitments while simultaneously removing perverse incentives for early retirement and disincentives for labour market participation and pension savings (see e.g. Brugiavini 1997). Reforms following the new distributional model have done both: they have cut prospective public expenditures while individualising duties and rights thus introducing this 'incentive' effect. But reformers also needed to answer the question of 'how' to make reform politically feasible: they needed to decide and justify how to apportion losses. In order to answer the 'how' question, political explanations have stressed on the nature of the bargaining games, trade-offs and veto players in different contexts as well as on the strategic 'packaging' of reforms (e.g. Natali and Rhodes 2004; Bonoli 2000; Bonoli and Palier 2000; and Chapters 2 and 3 in this volume).

The individualisation of pensions could have also provided a new element to legitimise reforms. In fact, pension schemes under the new distributional model can be much more appealing than bare retrenchment, because they can have a claim on equity and fairness. In a process of retrenchment in which reform necessary entails a distribution of losses, the best political move seems to be to make the distributional outcome an objective result from some unequivocally fair principle: 'to each what each has contributed', 'to each what each deserves'.<sup>36</sup> This could help cancel some existing privileges and simultaneously make benefit distribution more transparent. As the individual becomes responsible for providing for his or her old-age security, the state can shift the blame for unmet expectations back to the individual. Previously existing solidaristic policy

could be blamed for the distributional losses for young generations and the logic of individualisation could win over the logic of redistribution because the latter has failed to reproduce itself over time.<sup>37</sup> In order to make systems actuarially fair across generations they tended to be made actuarial also within generations. But the seemingly equitable distributional outcome of actuarial systems ('to each what each has paid in') can be an inequitable managing of the losses: young generations unavoidably lost while high income groups tended to gain by dropping out of the resource-pooling mechanisms in partly progressive benefit formulas. In the absence of effective cushioning devices, the shift of the risk back to the individual can immediately harm high-risk groups – especially women, low income workers, and individuals with precarious or intermittent working life histories (see Chapter 9 in this volume on the gender impact of reforms). This seems to be among the most relevant policy questions that pension reformers will need to address in the short future to adjust the distributional gaps left by recent pension reform in Europe.

## Notes

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- 2 Esping-Andersen (1990: 70).
- 3 In 1990, the old-age dependency ratio (population over 64 years old over population aged between 15 and 64) was 22 per cent in Italy, compared with 19 per cent for the European average (data from UN Population Division).
- 4 Basic equilibrium in PAYG schemes is given by  $sWL = PN$  where  $s$  is the PAYG contribution rate,  $W$  is the average real wage,  $L$  is the aggregate number of workers,  $P$  is the average real pension and  $N$  is the aggregate number of pensioners (Barr 2001: 96–97).
- 5 Early retirement ('seniority' pensions) was available for workers who had contributed for 35 years in the private sector, 25–20 in local public sector, and 20–15 in the central state (Vitali 1995: 17).
- 6 This applied to workers with less than 15 years of contributions. For older workers, wages of the last ten years were considered.
- 7 In order to avoid a rise in claims for means-tested benefits, eligibility under short contributory periods is only possible if the resulting benefit is at least 20 per cent higher than old-age social assistance.
- 8 The progressive scale for benefit calculation existing in the main private sector scheme before 1995 was the following: for earnings up to €37,884 =  $2\% * e * c$ ; for the partial amount up to €50,385 =  $1.6\% * e * c$ ; for the partial amount up to €62,887 =  $1.35\% * e * c$ ; for the partial amount up to €71,979 =  $1.1\% * e * c$ ; and for earnings over €71,979 =  $0.9\% * e * c$ ; where  $e$  is pensionable earnings and  $c$  is the number of years of contributions.
- 9 Legislative Decree 124/1993.
- 10 Legislative Decree 47/2000.
- 11 A portion of the salary which is set aside and paid back in a lump sum at the end of employment (Trattamento di fine rapporto (TFR)).
- 12 At the time of writing, the rule had not yet been implemented.

- 13 COVIP (2005: 267).
- 14 The growth in private pension benefits is based on the assumption that, starting in 2000, workers contribute 9.25 per cent of earnings (the 6.91 per cent for the TFR and an additional 2.34 per cent) into pension funds with a real return (net of administrative expenses) of 2.5 per cent (European Commission, Social Protection Committee (2002), Italian Statistical Appendix, p. 35).
- 15 European Commission and European Council (2003), Italian Statistical Appendix, p. 33, footnote 26.
- 16 Data for Sweden correspond to 1987 (based on Nordisk Socialstatistisk Komite, cited in Overbye 1992: 11). Data for the UK for the period 1982 (19.6 per cent) to 1995 (15.2 per cent), taken from Emmerson and Johnson (2001: 301).
- 17 Data for 2001, from European Commission and European Council (2003) for Sweden, and Davis (2004: 9) for the UK.
- 18 The reform was said to be 'actually neutral in this respect, as the level of the guarantee after tax was set so as to provide the same benefit level as the *folkpension*, after tax, in the old system' (Palmer and Wadensjö 2004: 240). In the absence of any earnings-related benefit, the value of the GP is below the minimum subsistence level set by the National Welfare Board, and additional means-tested housing allowances and social assistance can be claimed (Palmer and Wadensjö 2004).
- 19 The farmers' pension fund (KRUS) was often in deficit and required resources from the general budget. From 1992 to 1996, it raised only 0.1–0.2 per cent of GDP from workers' contributions, and received roughly 2 per cent of GDP from the state budget to finance benefits (Schrooten *et al.* 1998: 8).
- 20 The benefit formula was:  $P = 0.24 * BA + (0.013 * C + 0.007 * NC) * IE$ , where BA is the base amount; C is the number of contribution years, NC is the number of non-contributory years; and IE are individual earnings (Golinowska and Zukowski 2002: 199). Initially the base amount corresponded to 100 per cent of the average national wage, lowered to 91 per cent in 1993, raised to 93 per cent in 1994, and 94 per cent in 1996, with further increases of 1 percentage point per year to follow. The minimum benefit was 35 per cent of average wage in 1990 and 39 per cent in 1994.
- 21 The number of pension benefits rose from 5.5 to 7.2 million between 1989 and 1996 (Golinowska and Zukowski 2002: 202).
- 22 Grimmeisen (2003) tries to solve this puzzle by referring to the influence of the World Bank in Polish and Hungarian pension reform.
- 23 See DWP (2005: 33) for further details.
- 24 See Nesbitt (1995) for a historical account of the British pension system. See also Blake (2004) and Emmerson and Johnson (2001) for good reviews of the main structure, major reforms and outcomes of the system.
- 25 Pension expenditures in Britain were always significantly lower than in continental Europe. Projections done in the 1980s estimated that pension expenditure would rise from 7.7 per cent of GDP in 1984 to only 10.2 per cent in 2050 – a level not only below the rest of Europe but also below typically low-expenditure countries like Japan and the US (OECD 1988: 35).
- 26 Data from UK National Statistics, from [www.statistics.gov.uk](http://www.statistics.gov.uk).
- 27 Data from UK National Statistics, from [www.statistics.gov.uk](http://www.statistics.gov.uk).
- 28 This particular feature of UK policy led some authors to argue that the reforms in the 1980s were adopted for ideological rather than financial reasons (e.g. Nesbitt (1995), see also Bonoli (2000) for an account of how these ideas were traduced into policy).
- 29 See e.g. Whitehouse (2000) on the importance of information and financial literacy for UK pension policy.
- 30 The risk of individual longevity (i.e. longer individual survival than the estimated cohort life expectancy) continues to be pooled across the relevant cohort (individuals who live less than expected compensate for those who live longer).
- 31 In Sweden, for instance, workers can choose between two types of annuities: with a

- fixed 'guaranteed' interest rate of 3 per cent, or with the real return on accumulated funds. The former provides a fixed benefit level while the later makes benefits fluctuate according to financial returns. None of them provides full insurance against inflation. If inflation is higher than 3 per cent in the first case, or higher than obtained financial returns in the second, the real value of individual benefits will fall.
- 32 This includes generous pension credits for child-rearing, earnings-based indexation of the NDC benefit, and other regulatory benefits for funded accounts (guaranteed nominal 3 per cent return included in the calculation of the annuity and public administration of individual accounts to reduce management costs and risks).
  - 33 The importance of individual accounts is not equal across countries, with contribution levels ranging from 1 per cent in Denmark to 2 per cent in Latvia, 2.5 per cent in Sweden, 3 per cent in Bulgaria, 4–6 per cent in Estonia, 5 per cent in Croatia, 7.3 per cent in Poland and 8 per cent in Hungary. Relative replacement rates of PAYG and individual schemes therefore also vary across countries (International Social Security Association, Social Security Worldwide database at [www-ssw.issa.int](http://www-ssw.issa.int), data corresponding to year 2006).
  - 34 See, for instance, the case of Germany in Schmähl (2003: 22).
  - 35 More research should also be directed to the interaction between ideas and policies, and between institutional designs, ideas and social attitudes. See for example Cox (1998). For an interesting argument on the diffusion of ideas boosting innovation in pension reform see Orenstein (2003).
  - 36 Cichon (1999) has stressed on the 'selling' power of NDC schemes. Overall the argument refers to Amartya Sen's analysis of the 'equality of what' question in competing theories of social organisation – as social theories, social policies, in order to have some success need to be presented as pursuing equality of some feature which is regarded as a key value of social organisation (Sen 1992).
  - 37 Rhodes (1997: 60) has shown how 'among politicians of all parties there is a profound loss of confidence in "collective", public sector solutions in favour of either privatised or "marketised" social services'. There is however no agreement on how social attitudes are moving around this issue. Taylor-Gooby (1993: 89) argues that there is 'clear evidence of an *international* movement of attitudes ... away from the relatively interventionist position of the mid-1980s and earlier, towards a relatively free-market ideology in 1990'. Gelissen (2000) finds however continued widespread support for the welfare state. See Chapter 10 in this volume.

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# 7 The interdependence of the system of solidarity and the system of equivalence

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## **Research question and main conceptual ideas**

This chapter examines the process of reframing pension policy in three small countries: the Netherlands, Denmark and Sweden. The pension systems in these countries had broadly similar starting points, which we call common origins. However, pension policies in all three countries evolved in strikingly different directions. Yet despite their common origins and divergent pathways, each pension system nevertheless managed to produce surprisingly similar policy outcomes as measured by poverty and inequality levels. These conclusions appear to run counter to conventional assumptions on which the comparative study of pension policy rests (see also Anderson 2004).

The conceptual foundations of most studies of modern welfare states seem to rest on four major premises that are seldom made explicit and critically examined. We are critical of each assumption, and we hope that our review of the evolution and reframing of pension policy in three countries suggests a somewhat different direction of inquiry, one based on choice, changes and outcomes. Consider each of these concepts in a little more detail.

First is the idea that policy-makers had to choose between two conflicting design principles: we call these the principles of solidarity, best represented by universal, flat-rate pensions and the principle of equivalence, where pension benefits are broadly proportional to previous earnings. In the early history of pension policy it was believed that a country was forced to accept one or another of these principles, and the normative ideals that each of these principles implied. It was widely believed that once a country accepted one or another of these pathways it would be caught in the jaws of the iron law of path dependence where a major reframing of direction was considered politically unfeasible. Slowly, hybrids and sharp departures from these basic ideal types of pension designs surfaced. But the actual practice of implementing these principles, combined with more critical studies slowly revealed the weakness of each of these models, and pension policy in each country changed.

Second, is the concept of path dependence. Briefly this means that once a country starts down the particular pathway that it has chosen, it is very difficult to reframe its policy and create a radically different course of action. As Paul



Pierson puts it, 'the dead weight of previous institutional choices seriously limits their room for manoeuvre' (Pierson 2000: 810). And, by implication, basic reframing of policy always presents a daunting challenge and therefore may not be the most productive direction for a country to entertain and for research scholars to follow. Pierson and others argue (Thelen 2004) that we should look at incremental change/stability because radical path departure is politically difficult and thus far less common than incremental change, but this doesn't mean it does not happen. The claim that once a country chooses a pathway, it cannot reverse direction or 'choose a different path' very easily is of course the main tenet of the theory of path dependence. We make the opposite claim: the evidence suggests that with 50 years of experience, the solidarity system and all its variations became transformed, and this led to the paradoxical result that this system evolved towards its own negation, that is, towards both privatization, means-testing and earnings-related equivalence policies. We do not know of a single exception to this generalization. As the continuity of lifestyle became a governing principle, this in turn required moving beyond a purely public system of solidarity, based not on public dominance, but on a public-private mix which in practice took many forms and introduced a new vocabulary of regimes and pillars. These new forms included: public, private-collective (such as employer provided pensions) and private-personal arrangement (from private insurance to hybrid forms of individual accounts, which combined with private collective pension forms). These developments no longer made it tenable to rank welfare societies solely in terms of their level of public spending.

Third, is the assumption that similar pathways logically correspond to or create outcomes that are congruent with the underlying logic of the regime or pathway that is chosen. In other words it was assumed that policy regimes could be identified by policy inputs since these inputs were assumed to be a good proxy for policy outcomes. But these assumptions are not supported by empirical evidence. 'Less is known about welfare state arrangements and outcomes than about each of these separately, even though this relationship is arguably at the core of social policy research' (Cantillon 2003: 5). We believe that one cannot assume a natural link between a pathway or a regime type and its outcome. In this chapter we review the experience of three countries that produced surprisingly similar outcomes, with strikingly different types of policy inputs. This is a provocative finding, since it implies that similar outcomes can be achieved with a mix of quite different approaches, perhaps it is not the pathway or regime that matters, but rather how the programmes within the pathways are designed and implemented that is the crucial determinant of outcomes. A well designed public-private mix can be equally egalitarian in its outcomes as a publicly dominated solidarity approach. The assumption that a strong public transfer system can crowd out the demand for private transfers is a strong normative position, whose outcome is not decisively supported by empirical data (see, for example, Pedersen's study of crowding out (2004)). Studies which compare welfare state typologies with outcome indicators show that poverty is lowest in social democratic welfare states followed by conservative and liberal

welfare states, in this order (Korpi and Palme 1998). However, many scholars have pointed out that the link between policy inputs and well-being outcomes is very imperfect. 'Some 'conservative' welfare states (Benelux countries) have poverty rates that are almost as low as the social democratic one, and there are large differences among countries within the liberal cluster. In other words, welfare state type is not a very good predictor of outcomes in terms of income poverty and inequality. In the three countries we review in this chapter, there has been an evolution from a system of solidarity to a public-private mix. We claim that over time these countries radically reframed their pension systems and yet managed to maintain a system with low poverty and inequality outcomes. Thus a mixed public-private system could achieve outcomes similar to those achieved by systems based only on public solidarity. This reframing was not the result of single deliberate choice made at a single point in time, but rather the public-private mix evolved over time and resulted from many choices and non-choices.

Fourth, is the view that what happens in one policy sphere of a mixed public-private system is not independent of what happens in other spheres. In brief then, the system can be either tightly or loosely linked. How can we best identify the linkage of the public and private spheres? It is our strong contention that what emerges from a review of the three countries we analyse in this chapter, is that in the real world, countries set about to create linkages between their public systems of solidarity and their private systems of equivalence. They do so by assigning the first objective, solidarity, to the public sector, and the second objective, equivalence, to the private sphere. This is the case for each of the cases we present, but with variations. In short, what we see is not a choice between public solidarity or private equivalence, but a not well understood public-private mix that engages both principles. The philosophical justification for such an arrangement is developed in the writings of Michael Walzer who proposed a system of separation to buffer the paralysis that value conflict may bring from pursuing conflicting values. This can be achieved by pursuing one set of egalitarian values in one institutional structure (the basic public pension), and a different set of values in another structure (private earnings-related equivalence) (Thacher and Rein 2004). We believe the most important emergent issue in this evolution is how to maintain the autonomy of each of these spheres and also how to understand and regulate their interdependence. The objective is to ensure that no one pillar comes to dominate the totality of the pension system. What is needed is autonomy and interdependence concretely understood, by examining the interplay between the basic public flat-rate pension, on the one hand, and its linkage with private occupational pensions, on the other hand.

We think that a variety of design possibilities are found in both solidarity and equivalence based pensions systems that cut across existing regime classification of types. Pension systems evolve over time, they may be stable for long periods of time, but then they change. What happens in one sector or sphere of the public, private, personal mix is not independent of what happens in the other sectors. Hence pension linkage and the extent that they are tightly or loosely coupled is crucial to understanding how pension practice constitutes the income

package of aged households. In fact, pension systems that lie near the extremes of either pure solidarity or equivalence are unstable, and tend to produce in practice a blend, or hybrid, rather than a pure type, and this helps to avoid the dominance of one sphere over the other.

### **Common origins: three systems based on the principle of universal, flat-rate benefits**

It is perhaps somewhat surprising that Sweden, Denmark and the Netherlands, three countries with such a different political make-up, should converge in the design of a pension system guided by a commitment to the principle of solidarity based on universal, flat-rate benefits. The answer to this puzzle is that solidarity systems permit many variations around a common theme. As we shall see the public commitment to universalism, flat-rate benefits and contributions can be achieved through different policy designs, as long as the normative commitment to solidarity in its many different forms is preserved. It was more or less in the period between the two world wars that the ideas surrounding the norms of solidarity and its design variations took root in all three countries, which had very different political contexts.

In the Netherlands, the tension between the religious parties, with their commitment to subsidiarity, and the socialists' commitment to public intervention constituted the political climax for the design of pension policy. The Confessional parties, led by the Catholic party, took the view that social provision in general should be basically and primarily an individual affair to be managed through the savings and efforts of individuals and households. Applied to pension policy, this normative view reflected the idea that it was the responsibility of the individual to make contributions over their lifetime to pay for retirement. It is this approach which embodies the Dutch model that was enacted as the Old Age Act in 1919. This legislation launched the first round of this historic debate. It was eventually resolved in favour of premium contributions, to be paid for at least 24 years, following actuarial principles, before a claim to a pension could be honoured.

The debate continued in a new societal context when the Dutch government in exile in Britain during the Second World War submitted a report expressing its commitment to the competing view that it was the responsibility of society to protect its members by providing contribution-free pensions to be financed from general revenue. Those who did not qualify were not eligible for benefits. This was the position recommended in the 1947 Old Age Emergency Act, which was accepted as an interim measure. But when the government in exile returned it was clear that support for a state pension had evaporated. In this debate, not surprisingly, unions and socialists argued that entitlements should be based on the principle of need, not contribution, and therefore financed out of general tax revenues. In this historic conflict over basic principles, the universal public pension perspective was eventually defeated.

But in the interim period between the Emergency Act and the passage of the permanent Old Age Pension system in 1956, the Netherlands did enjoy a

means-tested programme financed from general revenues, reaching a large share of the aged population. Eligibility was carefully monitored, to make sure that those who did not work before retirement were not eligible, even if they were in need. So for a little more than a decade before the principle of contribution was adopted, there was a modest public pension, sometimes described as a 'bottom pension', since it was assumed that individuals would need to supplement the pension with savings or life insurance protection. The Emergency Act was very popular and people talked and acclaimed their experience of 'the drawing from Drees' who was the head of the Labour Party at the time, to suggest the wide public acceptance of the Emergency Pension Act (Oversloot 1986: 11).

The Dutch public model of old-age pensions, which became law in 1957 and is still in force today, created a universal pension insurance which can best be described as the provision of equal, flat-rate benefits for all aged, but these benefits would be 'earned' via residence in the country and the payment of premium contributions over a 50-year period by those considered most capable of financing the system, breadwinner wage-earners who would benefit from the system in their old age. This financing structure was also meant to promote solidarity between wage-earners and non wage-earners. The contribution ceiling was set fairly low, about equal to average earnings (the level at which people start paying income tax), in order not to discourage the development of private sector occupational pensions. Employer contributions to finance pensions were never politically considered as an option.

Turning next to the Swedish debate about the Pension Insurance Act of 1913, the concept of voluntarism had already been replaced by an active interventionist, collective, liberal conception of social policy which intellectually accepted a concept of a people's pension, and this also required accepting the idea of compulsory state contributory insurance. This was perhaps not very different from the Dutch idea of contributions, but in the Dutch model it was not the state, but the private and personal sphere that was to provide the major organizational initiative driving the contributory pension system. By contrast Sweden accepted a dominant role for the state. But what was not resolved in the Swedish scheme was who was to contribute to the new '*folkpension*' and who was to be excluded, because they were already covered by some other form of social or personal protection. From the outset, the Swedes were reluctant to impose a mandatory, compulsory system of social legislation that would include all segments of society. As Berge puts it, 'the idea rather, was to introduce the idea of legal force with the specific aim of providing some security to those who were unable or unwilling to provide it by other means' (Berge 1999: 208).

Baldwin (1990) argues that the basic line of disagreement about the structure of pension policy at this time was whether pensions should be contributory and cover only industrial workers, or whether pensions should also include the agrarian self-employed. The social democrats advocated wage-earner pensions financed by employers and employee contributions, while the agrarians wanted universal non-contributory pensions. That farmers were self-employed largely explains their resistance to employer/employee contributions since they would

have to pay both parts. After more than a decade of discussion and two commissions of inquiry, the Swedish parliament finally adopted pension legislation based on universalism, partial state financing and graduated employee contributions (see Baldwin 1990: 83–94). As Baldwin (1990: 90) puts it, the new pension legislation ‘reflected farmers’ newfound political importance, an outcome of their longstanding campaign for social policy tailored to rural needs’.

There was a clear willingness to impose a paternalistic policy of interfering with a person’s personal freedom for his own good. With this doctrine clearly in place then all Swedes without disability or old-age insurance were forced to join the People’s Pension. However all other persons with some form of pension insurance could apply for an exemption and ‘opt out’ of the obligation to pay contributions, or they could choose to remain in the People’s Pension. Opting out, not surprisingly, created a situation where the number of exempted persons who chose to opt out grew steadily. With these developments the People’s Pension became increasingly viewed as a form of poor relief. So there was support for a decision that all exemptions and opting out should be eliminated. A first such step was only taken in 1946 with the parliamentary decision to limit means-testing and to introduce ‘a substantial flat-rate benefit’ (Berge 1999: 273). This legislation interpreted contributions as a tax and the first paragraph of the law declared that the ‘Swedish Citizen ... is entitled to People’s Pension.’ So the pension was accepted not based on contributions but based on citizenship rights or universal entitlement.

The Danish law of 1891 took a different form than that of Sweden because it was a pension system that was universal, tax financed and means-tested (Ploug 2003) and therefore the issues surrounding state compulsion and state exemptions from contributions were not very important. Eligibility for benefits was based on a test of need and not on citizenship. All persons over 60 years of age were eligible to a flat-rate pension if they met the test of need, broadly defined as lacking alternative means of support. But, in practice, this law meant that Denmark, like Sweden and the Netherlands, was moving from the stringency of Poor Law administration to the leniency of this new form of public pensions as the means of allocating public revenues to the needy. Leniency in administration meant that few eligible individuals who applied for benefits were turned down, and thus the system was *de facto* virtually universal. Denmark was perhaps the only one of our three countries that had adopted a means-test early on and maintained it, rather than having a contribution or citizenship criterion for determining who should receive benefits.

Flat-rate benefits and flat-rate contributions are the guiding principle of the design of public pension, and this eschews a commitment to a public system based on equivalence. The Danish commitment to means-testing, and the Swedish model of a universal *folkpension* offer views of solidarity that are at once different from and similar to each other, and also from the Dutch framework. Given this variety of practices, how can we justify our claim that despite this non-uniformity of design, there is nevertheless a unifying conception that

was integrated around the concept of solidarity, and that it is this common idea that supports the argument that all three countries shared a common origin? We offer five arguments to support this position. First, the principles of solidarity in the early twentieth century developed slowly over a quarter of a century, before they matured and established the theory of solidarity which we describe as the period of common origins. Second, the distinctive feature of mature solidarity was that of a public system of flat-rate, uniform benefits whether financed from contributions or general taxation. Third, the benefits were universally available to virtually the entire aged population, even when these benefits were distributed based on need, because the rules of eligibility were relaxed in practice so that virtually no one was excluded. When the system was based on contributions, the principle of universality was also honoured by providing benefits to those with no earnings, or very low earnings, and therefore not required to pay income taxes. So in practice, neither means-testing nor universal mandating were sufficiently exclusionary to undermine the principle of universality. Fourth, benefits were as a matter of principle redistributive, accounting for a larger share of the net total income at the bottom end of the income distribution, even if contributions accounted for a larger share of total income of the low-wage employed population. Non-wage-earners could also earn entitlement for flat-rate pensions. While the arithmetic of net redistribution may be hard to calculate because of limitations of data, the objective did seem clear. Fifth, the principle of public solidarity was signalled by the reluctance to introduce a public programme based on the principle of equivalence interpreted as benefits which were related to earnings rather than based on flat-rate contributions, flat-rate benefits and redistribution. Once equivalence entered the public domain, the country entered the period of transition or development into a public-private mix, but the history of that transition was different in each of the countries we are examining.

### **Diverging evolutions: from solidarity to a public-private mix based on both solidarity and equivalence**

#### ***The Swedish story***

There are two major reform periods in Sweden. The first occurred in the late 1950s with the ATP pension reform. It represented the first paradigm shift when it introduced the principle of earnings-related equivalence into the public pension system. The programme also created a publicly managed AP fund, which accounted for about 35 per cent of GDP in the early 1990s. Compared to our other countries these innovations were a bold violation of the principles on which solidarity systems were premised. The ATP system was designed to supplement the benefits of the basic *folkpension* and other means-tested supplements, and was introduced after intense political conflict (Heclo 1974; Anderson 2005).

The new ATP was closely linked to the existing *folkpension*. In comparison



to the Dutch AOW (the flat-rate pension), the Swedish *folkpension* was always relatively low. It was never the equivalent of a minimum income, and for many pensioners it had to be augmented with both a pension supplement and special housing allowances. In 1935 it was replaced by the flat-rate basic pension (*folkpension*), and in 1948, it was raised significantly so that it would cover basic living costs. By the early 1950s, the size of the pension equalled about 30 per cent of an average industrial wage (Ackerby 1992). We believe that the *folkpension* as a percentage of average earnings has actually decreased since the Second World War, especially after the ATP was introduced, and as more and more workers had access to earnings-related pensions.

The ATP was a huge success because it improved the economic well-being of pensioners relative to the working population. The need for a second wave of reform was essentially grounded in the fear that the ATP system was not financially sustainable if long-term economic growth continued to fall below 2 per cent per annum. In the mid-1980s actuarial reports demonstrated that the fiscal viability of the pension system depended on strong economic growth. So when Sweden experienced a deep post-war recession with declining growth rates, unemployment increasing to 13 per cent, and the budget deficit to 12.3 per cent of GDP, the fiscal viability of the pension system came into serious question. Taken together these issues set the stage to seriously consider significant pension reform, and in the mid-1980s a Pension Commission was formed to recommend pension reform. The dramatic devaluation of the currency in 1992, and the further deterioration of the economy seemed to demonstrate the urgency of pension reform. The Pension Commission appointed in the early 1980s met for six years but failed to agree on concrete proposals. By the early 1990s, experts and politicians alike agreed on what was wrong with the pension system but disagreed about which reform path to take. A parliamentary committee with representatives from all major parties agreed to negotiate a compromise, and the reform was passed in two large steps, in 1994 and 1998. The new legislation redefined in bold new ways the public and private boundaries. Three radically new ideas were introduced: mandatory public notional accounts, a premium reserve and a new pension guarantee.

Notional accounts were based on lifetime of contributions, and replaced the ATP scheme of 30 years of contributions and benefits based on the 15 best years. They thus corrected some of the inequities in ATP system, since the 30 and 15 year rules disadvantaged blue-collar workers with long careers and flatter lifetime earnings, compared to white-collar workers with increasing earnings profiles. The value of notional benefits is annuitized, taking into account the gender-neutral life expectancy of the retiring cohort. This new pension is called the 'income pension' and is financed by contributions of 15 per cent of payroll shared by employers and employees. This income is supplemented by a 'premium reserve' which 'carved out' a part of the public pension system equal to 2.5 per cent of wages, for investment in the equity market (for more details see Anderson and Weaver 2001). Individuals can choose from among many different types of plans depending on their willingness to take risks, and the state

provides a default fund for those who are not willing or able to make such investment decisions. In the American debate about pension reform, this radical step was interpreted as the privatization of the public pension system, but the Swedish system of premium reserves is administered by an active public sector and is therefore not an example of privatization as conceived in the American debate. Finally, the new guaranteed pension assures individuals a minimum income which was higher than the combination of the *folkpension* and the pension supplement in the old pension system.

On the other hand, Sweden has a system of contractual pensions which has a long history. Prior to the ATP reform, contribution rates for this private sector pension were as high as 24 per cent of the annual salary, with two-thirds of that amount paid by employers. By the 1970s, 90 per cent of Swedish workers were covered in these contractual plans. One way to interpret these contractual pensions in Sweden is to view them as part of a broader series of nested supplementary pensions into which the Swedish system seems to have evolved. The contractual occupational pension is a supplement to the public earnings-related pension which only protects an individual up to a ceiling, which is only one and a half times the average wage of a full-time worker. For those with earnings below the ceiling, contractual pensions add about 10 per cent to the public pension; for those with income above the ceiling, it covers income excluded in the public scheme and provides an additional 10 per cent of coverage. For example, average income earners receive a public pension of about 65 per cent of earnings, plus another 10 per cent from the contractual scheme for a total replacement rate of 75 per cent. Those with income above the ceiling also receive a combined replacement rate of 75 per cent for all income when the contractual pension is included.

Contractual pensions have significantly changed to accommodate the new pension reform. There are four major occupational pension schemes. Those for white-collar workers, those for blue-collar workers, those for local government workers and those for civil servants. All these schemes, except for the white-collar workers', have changed their benefit structure to that of a defined-contribution plan to be consistent with the public sector (notional defined-contribution (NDC)) 'income pension' and the funded defined-contribution (FDC) scheme, the premium reserve. This was part of broad effort to coordinate the contractual schemes with the two publicly mandated programmes in order to support a model of a large public sector supplemented by a smaller contractual sector. This is clearly an effort to maintain public dominance. In 1996, 83 per cent of men and 75 per cent of women aged 65–69 received income from one or more contractual occupational pensions, and these schemes accounted for a significantly larger share of the income package of higher income men in the top three deciles of the income distribution (Palmer and Wadensjö 2004). At the time of writing this chapter, the white-collar workers are still resisting being folded into the new defined-contribution reform. Rather than shifting to a new occupational system of defined-contributions that can more readily be integrated with the new public NDC scheme,



white-collar unions prefer a financially more attractive contractual arrangements for the present defined-benefit plan that they enjoy.

### ***The Dutch story***

The flat-rate public pension in the Netherlands (AOW) was originally constructed as a breadwinner pension. Only the breadwinner in any household paid wage-related contributions and, based on a residency requirement, all resident breadwinners 'earned' benefits, a mechanism by which the pension could be constructed as an 'insurance'. The amount of the AOW benefit is relatively high when compared to other basic pensions. Unlike the Swedish *folkpension*, the AOW was designed as a minimum income. Also unlike Sweden, the Netherlands totally rejected the introduction of a public system of earnings-related equivalence, and has instead relied upon private occupational defined benefits to supplement the basic flat-rate pension. Many Dutch pension experts assumed that over time, as the private pension system matured, it would slowly overtake the benefits provided in public system. In the 1980s and 1990s, during a period of economic hardship, there was an effort to financially retrench the flat-rate old-age pension (AOW), mainly by the suspension of indexation. This retrenchment movement would have supported the forecast that the private system over time would become dominant and the public flat-rate benefit system would become residual. But the effort at the retrenchment of the public pension system backfired. Aged groups politically mobilized and managed to contribute to the change of the government in 1994, and to make the AOW solvent by partially funding the programme and decreasing its reliance on the state budget, while also increasing the value of benefits and capping contributions at 18.5 per cent of qualifying wages. The Dutch experience seems to suggest that when solidarity is tied to a system of contributions by individuals and not by employers, it is able to overcome periods of retrenchment and also to mobilize political support to protect a flat-rate universal programme as an integral foundational component of the pension system.

From its introduction, the AOW pension was explicitly linked to occupational pensions in the public and private sector. Occupational pensions have a long history in the Netherlands, and in the last two to three decades they have grown significantly. Surprisingly the structure of supplementary pensions in the Netherlands also contains important elements of solidarity. The first type of solidarity or risk-pooling is within sectors and within companies, since these are the two main types of supplementary pensions. All civil servants (and all metalworkers, etc.) are in the same pension fund, and all employees in large corporations like Philips are in the same scheme. The second type of solidarity or redistribution is more problematic: since most funds are based on a final salary formula of 70 per cent of last wages including the AOW, this means redistribution from lower to higher income workers and from those with flat or slowly rising earnings to those with high earning at the end of their career. This type of solidarity is difficult to defend.

This second type of redistribution is based on the mechanism by which public and private pensions are linked, the 'franchise'. Occupational pensions are overwhelmingly defined-benefit, and workers earn pension rights only on the part of their income above the so-called 'franchise'. Dutch occupational pensions are based on the convention, or non-binding understanding between the social partners, that workers in retirement could expect to receive 70 per cent of their final wages. It represents a norm guiding conventional expectations that influences policy deliberations. But the convention of norms or expectations does not faithfully reflect actual practice since only 57 per cent of workers actually receive pensions based on final earning schemes. Part of the reason for this anomaly is that there is much diversity across the more than 900 different pension funds, so one would expect that practice would be different, but within this diversity over 70 per cent of the funds are of two types: industry-wide and firm-sponsored schemes. But the whole structure of the Dutch pension system is organized so that the defined-benefit plan of occupational pensions would top up the basic pensions so that a 70 per cent replacement rate would be reached. The franchise is the adjustment mechanism that linked the public and the private pensions systems. Private plans take into account the existences of public pensions, by paying an occupational pension benefit only on the income above the franchise. Here the convention of using the 70 per cent replacement rate was crucial for establishing the relative responsibility of the public and private system in reaching this targeted goal. The government was eager to promote rule changes in the computation of the 'franchise', which determines what proportion of public benefits is offset in the private sphere. Most second-tier pension schemes use the franchise approach in computing their obligations, but there is disagreement on what level of public benefits should be included in computing the franchise. For incomes below the franchise level, no pension contributions are paid by the private sector. This means that the public franchise level should accurately reflect the expected level of total public benefits, otherwise pensions will be underfinanced. The state feels that the level of the franchise in many private pension schemes has not kept pace with changes in the labour market and is therefore set too high, leading to higher public spending and underfinancing of the flat-rate pension because of evasion in meeting private sector obligations.

In the Netherlands, the social partners manage occupational pensions and the government sets the regulatory framework through legislation. If the government wants to push the social partners to change occupational pension schemes, the typical approach is to try to strike a deal with the social partners and to write down the elements of the bargain in a 'covenant'. The social partners then try to accommodate the government's goals, knowing that if they fail, the government can turn to legislation. Absent in these negotiations are the income sources from the personal sector, life insurance, savings and personal rather than occupational tax deferred annuities. In the personal savings sector individuals are free to enter and leave and thereby have more control over the terms of the contract. In the case of private sector arrangements individuals are not free to join and to leave

since the terms of the benefits are attached to the job and subject to contractual conditions that unions can get agreement on. So we can see the public-private linkage is not only variable, but also complex.

The best description of the evolution of the Dutch pension system is that there has been 'a lack of mold breaking pension reform' (van Riel *et al.* 2003: 16). This conclusion is in sharp contrast with the Swedish planned 'paradigm shift', and the Danish transformation of occupational pensions that arose not out of the weakness of pension system, but the reframing of contractual pensions into a decentralized, defined-contribution system. This is not to say that the pace of change in Dutch occupational pensions has not been substantial, however.

### ***The Danish story***

The Danish *folkpension* was always bigger than the Swedish one, and we think this was so because the Danes never managed to introduce a decent public earnings-related pension scheme. What was controversial was whether an earnings-related supplement should be added to the scheme as was done in Sweden. It is interesting to review the intellectual and political arguments that lay at the heart of the failure of two efforts during the 1970s and 1980s, and then to consider why in 1991 the Danes were willing to introduce a contractual, decentralized occupational pension combined with individual savings accounts, which in effect introduced, in the private labour market, what they were unwilling to accept in the public sector. At the heart of the Danish debate against the public earnings-related programme was a belief that a system of equivalence would reinforce inequalities and thus undermine the commitment to solidarity. Ploug (2003) identifies three types of inequalities that were of concern. First were the inequalities created by those who presently had earning supplements and those who did not. Second were the inequalities that would be created between current and future age cohorts due to the introduction of funded, defined-contribution plans that take time to mature. This argument was, in a different context, also advanced by American economists who supported the creation of an inter-generational accounting system, which could project the tax and benefits of future generations compared to the present generation. The third reason was the socialist argument, that it was a mistake to duplicate in old age the income inequalities that existed in the labour market. Despite these objections there were two efforts to create a system of equivalence. In 1964 a Swedish-style public earnings-related supplement was passed by the parliament, but the benefits were very low. In 1967 the government tried again, but contributions were small and based on hours worked, rather than income earned. In part, this happened since the *folkpension* was subject to an income test. However, few pensioners fail this test.<sup>1</sup> The earnings-related Danish supplementary pension was largely symbolic and was surrounded by much ambivalence, since it was argued that a strong earnings-related programme would reproduce in retirement the inequalities that exist in the market wage system.

The story in Denmark is different from that of Sweden and the Netherlands. Public policy seems to be much more focused on lowering consumption by promoting personal savings, presumably as a way of dealing with inflation. In 1982 the policy seemed to focus on voluntary savings, since these savings both paid high interest (close to 10 per cent) and contributions were tax exempt. This made savings accounts very attractive. But at the same time the policy clashed with the Danish concern about using tax and pension policy to reproduce in retirement the inequalities that prevailed in the market. So it is not surprising that the Social Democratic minority government tried to tax interest on these pension savings accounts. But the effort failed and the government resigned. The next Conservative government did introduce an interest rate tax of 2 per cent of pension savings when the real interest rate exceeded 3.5 percent. The interest rate at the time the legislation passed was still much higher, so the incentive to invest in these savings accounts was still very attractive. But there was agreement within the government to continue to use pension savings accounts as a new and important instrument of pension policy. In 1999 the government created a special savings programme (SP) which mandated contributions of 1 per cent of total gross earnings. This created a new tier in the pension system, which when it matures will be higher than the earnings-related pension system (ATP) (Ploug 2003: 73, fn. 5). A projection of collective pensions arrangements in the year 2045 predicts that the mandatory personal saving system when combined with the modest ATP pensions account will equal the value of the basic pension for the top 60 per cent of the income distribution of aged households.<sup>2</sup> Moreover it will dominate the income package of the top end of the income distribution when combined with the value of projected occupational pensions.

Consider next how employment-related contractual occupational benefits in the state and the private sector developed in Denmark. It was the conflict between employers and unions that shaped the evolution of local pension arrangements, since the unions not only wanted to create a central pension fund, but also wanted to manage these funds. Employers rejected such a scheme since they viewed it as a political attempt to redistribute power, and instead they wanted individual arrangements at the enterprise level. The route to private occupational pension was blocked partly because of this unresolved normative debate. Employees and employers could not agree on a formula for the governance of the funded occupational pension. Eventually the deadlock was broken by the initiative of the metalworkers' union, who reached an agreement in 1991 for a decentralized pension system that covered only the members of their union. Governance of the fund was to be based on equal representation of employers and employees. This decision to negotiate only for their workers at the local level was followed by a dramatic norm change, as all the other unions followed this new model. Today most occupational schemes are defined-contribution plans. The coverage rate of occupational pensions was 84 per cent in 1997, but prior to the 1980s only about one-third of wage-earners were covered by occupational pensions and most of these were in the public sector. As the system

matures the income package of the retired will shift from public dominance to a public-private mix of the *folkpension* and occupational pensions. The funded schemes also meant that pension assets in Denmark are a growing source of investment capital. In 2000, pension assets equalled about 100 per cent of GDP, with private schemes accounting for about three-quarters of this. Statutory schemes, especially ATP, account for the rest. As a percentage of GDP pension assets have doubled since 1987 (Ministry of Finance 2002).

This rather dramatic transformation of Danish pensions from a *folkpension* based on national flat-rate benefits into a robust public-private mix did not have its origins in the financial instability of the prevailing public pension system. Future pensions were not burdened with excessive public pension costs. The opposite was true due to the relative low level of pension benefits and pension costs. On the other hand, it was widely accepted that there was little scope to increase the benefit adequacy of the present *folkpension* system which had to depend on financing from general taxation.

### ***Divergent evolutions: a summary***

Systems of solidarity are now evolving into their own negation. In the process of reform, countries adopted different developments. Not only did Sweden diverge from the pensions arrangements in the Netherlands and Denmark, it diverged radically from its own 1960 reform that had ushered in a new PAYG earnings-related pension (ATP) in combination with a flat-rate and transfer-tested pension supplement. The new pension system of 1994/1998 is both very complicated and interesting. In the new system each generation pays for itself. This was made possible by introducing a system of notional pension accounts. An internal rate of return is imputed at the time of retirement of a new age cohort, and the pension is then annuitized. The longevity of the cohort is estimated based on a gender neutral projection at the time the individual retires, on the assumption that future generations live longer and therefore their pension outlays are higher. During a person's working life there are periods of unemployment, sickness, education and military service when the individual does not contribute to his/her retirement. How then are these unfunded liabilities to be paid? In Sweden about 11 per cent of all contributions come from the payment of other insurance funds. If there is no funding source to make contributions to this notional contribution system then the asset pool that is credited to the individual is correspondingly reduced. The premium reserve is financed by 2.5 percentage points of total contributions (18.5 per cent of qualifying wages), which are set aside and placed in an investment fund that the individual chooses. Like the NDC, it is also based on the contributions accumulated at the time of retirement from the individual's investment in market equities. The contributions are designed to cover the cost of all the pensions that individuals receive at the time of retirement. The net effect of the introduction of these principles is that the redistributive role of pensions is correspondingly reduced and the system comes closer to functioning as an insurance system. This does not mean that all redistributive components of

the system have been eliminated. An income guarantee is available in the form of a means-tested benefit which combines the earlier *folkpension* and pension supplement. Not all means are subject to this test, only other transfers are included, thus introducing the principle of transfer testing rather than income testing. The guarantee is financed from general government revenue.

In the Netherlands the efforts to create a generous basic pension system paralleled efforts to create a strong private occupational sector. Later, these developments led to pressure for a strong private sector to help offset the growing costs of this flat-rate, universal pension. Through tight linkage the public and private domains become both autonomous and interdependent. The stronger the private sector was, the lower was the need for the basic pension. Some analysts predicted that this was an opportunity to retrench the basic public pension. But politics intervened, as the aged activists mobilized politically to ward off any attempt to develop a strategy to contain the growth of the public basic pension. The purple coalition was the outcome and the practical lesson was that substantial retrenchment of the public pension was not politically viable. The outcome today is that the public and the private occupational pension each account for about 4 per cent of GDP. The occupational pension system creatively moved, with government pressure, toward a bold scheme, namely the goal of 100 per cent coverage. The increased numbers of women in the labour market would also find a private sector receptive to covering workers with a part-time and part-year commitment to employment. Thus a new market opened and the private pension system seemed willing to fill the gap.

In Denmark the decision was to reluctantly pursue flat-rate universal pensions with some means-testing supplemented by two very modest benefits which were originally intended to be based on the principle of earnings-related equivalence, but in practice became only a supplement to the basic pension. The first earnings-related initiative started with the introduction of public earnings-related benefits for civil servants and then in 1991 with a contractual decentralized private pension for private sector workers. With a weak public flat-rate benefit, those above the means-tested level saved more and those below the means-tested level more or less did not save at all. Paradoxically, a means-tested basic pension organized on these principles exacerbated the demand for the private sector to augment the weakness of the public sphere. This in turn increased, at least to some extent, inequalities among the aged. Private occupational developments were caught in a quagmire; the unions wanted a national defined-benefit scheme whose accumulated assets would be controlled by the unions. Not surprisingly, employers opposed the scheme. At the same time union opposition for a public earnings-related pension led to a second quagmire which was the inability to follow the Swedish model of introducing the principle of equivalence in the public sector. The paralysis was broken when one strong union broke ranks and settled for a decentralized private occupational pension based on defined-contribution. Almost all the unions followed suit and coverage of private, decentralized, defined-contributions became the norm for the country as a whole. This was the evolution of a

private pension system directly at odds with the Swedish model, a clear example of divergent development.

### **Similar outcomes: low poverty and inequality**

The main evidence, and the argument that we can infer from it, is based on an account of the actual experience countries face when they create a linkage between flat-rate, universal benefits and the public and private spheres. This experience turns out to be very surprising since it runs counter to the theory that a strong public pension should 'crowd out' the demand for private sector pensions. What we found is a more subtle and complicated pattern.

The intellectual puzzle underlying the analysis of similar outcomes is whether there is one model for reducing poverty and inequality and improving the wellbeing of the aged, or there are multiple models to realize this aim. The dominant argument in the welfare state literature is that there is a single model to realize these objectives and the alternative models, such as the residual model or the industrial achievement models, are not capable of creating a stable and economically and politically viable approach to realize redistributive and universal norms. Sweden is the model of social democracy, and it is widely regarded as the only country with the institutional pre-conditions necessary to realize these social democratic ideals. Hybrid models are rejected as inefficient and therefore the very idea of many models to realize a common aim is rejected. Of course, there is a growing body of literature in economics which have in common the acceptance of a multi-pillar model. The most vocal scholar is Dani Rodrik. His argument about the pre-conditions necessary for economic growth captures the main theme of this chapter, namely that:

there is no unique correspondence between the functions that good institutions perform and the form that such institutions take. Reformers have substantial room for creatively packaging these principles into institutional designs that are sensitive to local constraints and take advantage of local opportunities. Successful countries are those that have used this room wisely.

(Rodrik 2003: 3)

Briefly then we want to make a similar argument for pension reform, namely that there are multiple models to reach similar social policy goals of stability and redistribution.

The Swedish model can no longer be characterized as a system based on universal coverage via public flat-rate pensions. The principle of equivalence, in its many different forms, has displaced the original and dominant single model of solidarity as combining the social democratic ideal of universal access and flat-rate benefits in the public sector. In fact, all three countries have evolved into different types of public-private mixes. This suggests that there are many policy



designs that can yield similar outcomes. We believe that there must also be many models and not one single model for realizing goals of protection against economic risk (Gross 2005: 6) and creating guarantees that provide a ballast for fluctuating income. The protection against risk has recently surfaced as an important, but neglected social goal (see Hacker 2004). These new risks are signalled in the US by the decline of defined-benefit plans and employer-provided health insurance and the growth of defined-contribution plans that shift uncertainty from the risks of firms to the risks of individuals. The Swedish pension reform also entailed greater risk with the introduction of notional defined contribution accounts and premium pensions. Anderson and Weaver (2001: 25) interpret these developments in sharply critical terms arguing that 'the new system will lose much of its redistributive character' and that 'two-thirds of workers with 40 years of contributions will be net losers'. In the new Swedish pension plan Palmer is more optimistic as he gives the new system a somewhat different interpretation. He points out that the contractual private occupational pension is equal to about 2 per cent of total contributions and when this is added to the 2.5 per cent of the premium pension then 'the typical new entrant into the private sector (has) a combined contribution rate of 4.5 per cent' (Palmer 2002: 175). The two combined private income sources affect the balance of winners and losers depending on market performance.

What is the evidence for common outcomes in the three countries we are studying? We have put together data from three sources: The European Community Household Panel, OECD Europe data analysed by Peter Whiteford, and a recent publication of *The Economist*. These data share a common weakness in that they only cover the period since the late 1990s. Many of the pension reforms we reviewed were only introduced during the late 1990s, so the time horizon is simply not long enough to provide an adequate test of the outcome hypothesis that the rates are essentially similar. All we can do is to report findings for the late 1990s. Still the data are informative and generally confirm our hypothesis of converging patterns (see Tables 7.1, 7.2 and 7.3).

What the data broadly show is that all three countries have similar values for poverty rates at 50 per cent of median equivalent income (Table 7.1), pension assets as a percentage of GDP (Table 7.2), and public social security spending as a percentage of GDP (Table 7.3). The poverty rate is below 7 per cent of the aged population in all three countries. Pension assets increased sharply in all countries, up to 110 per cent of GDP in Sweden, 85 per cent in Denmark, and 160 per cent in the Netherlands (year 2002, see Table 7.2). These rates are clearly high but they are also broadly similar even though the trends in Denmark are still lagging behind the other countries. Parenthetically, the lack of common definitions across these countries make these comparisons difficult. Moreover, it is not surprising to find quite different numbers depending on the publication sources. There are also anomalies in the data. Why do the poverty rates for different poverty definitions increase so sharply in Denmark but only modestly in Sweden? Perhaps better data may make the storyline more clear, but perhaps it might also exacerbate some of the anomalies.



*Table 7.1 Poverty rates of aged population (percentages)*

<i>Country</i>	<i>Year</i>	<i>Poverty rate at 40% of median equivalent income</i>	<i>Poverty rate at 50% of median equivalent income</i>	<i>Poverty rates 60% of median equivalent income*</i>
Denmark	1997	1.7	6.6	31.0
Netherlands	1994	1.4	2.4	4.0
Sweden	1995	0.8	2.7	10.0

Sources: First two columns from LIS key figures, 'Relative Poverty Rates for the Total Population, Children and Elderly'. <http://www.lisproject.org/keyfigures/povertytable.htm>, accessed 23 January 2006. Last column from Bradshaw and Mayhew (2003), Figure 8.

Note

\* Statistics for this column are for 2000 for all three countries.

*Table 7.2* Pension assets and life insurance assets (percentages of GDP)

	1996	2002
Denmark pensions	23.9	85
Life insurance		75
Netherlands pensions	87.3	160
Life insurance		75
Sweden pensions	32.6	110
Life insurance		75

Sources: OECD (1998) and *The Economist* (2003).

*Table 7.3* Total social expenditures and old-age pension expenditure (percentages of GDP)

	1980	1990	1998	1980–1990	1990–1996
<b>Total social expenditure</b>					
Denmark	29.1	29.3	29.8	0.3	0.5
Netherlands	27.3	27.9	23.9	0.7	–4.0
Sweden	29.3	31.0	31.0	2.0	0.0
<b>Age pensions</b>					
Denmark	5.8	6.3	6.8	0.5	0.5
Netherlands	6.5	7.2	6.2	0.7	–1.0
Sweden	6.7	7.2	7.5	0.6	0.2

Source: Whiteford (2002).

The most striking feature of Table 7.3 is the broadly similar pattern of changes in the level of total social expenditure and pension spending over time. However there are some divergent patterns. The Dutch data show a decline of about 4 per cent in social expenditure and 1 per cent in pension expenditure while the other countries show a general pattern of increases. This is clearly the effect of the budget consolidation measures carried out by the Christian Democratic-led governments of the late 1980s and early 1990s. Table 7.4 shows that there is a rather uniform pattern in the disposable income of retirees in the three countries, with the bottom three deciles increasing only about 20 per cent, the next three deciles about 33 per cent, and the top deciles about 45 per cent. There is therefore no evidence of declining income inequality of the retired population.

The convergence of our three countries is very clearly illustrated by Figure 7.1. The public and private pension expenditures as a proportion of the earning of prime working age household is our measure of the adequacy of the pension system. This measure is then graphically compared to each country's poverty rates. The graph clearly shows that Sweden, Denmark and the Netherlands all have high relative spending for the combination of public and private pensions and low poverty rates. But Canada, Germany and Switzerland also have high relative spending and low poverty rates. This suggests that there are many

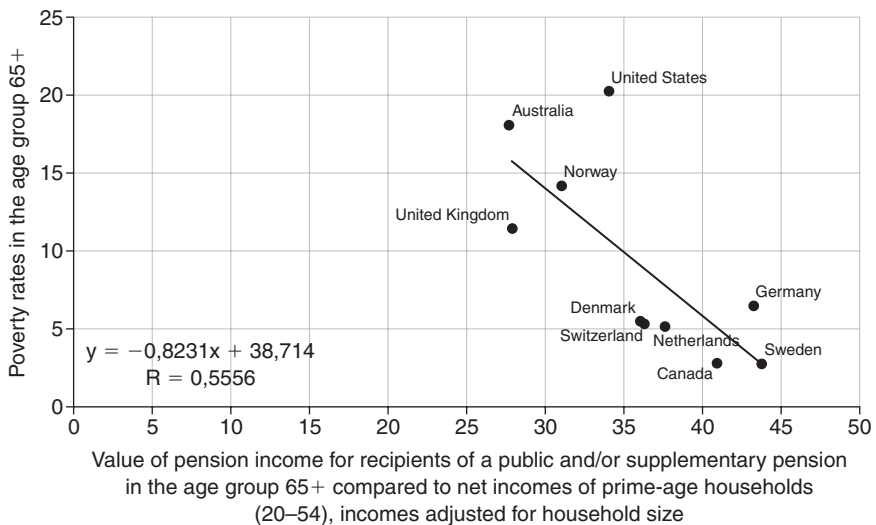
different ways of achieving these outcomes. The drawback of this data is that the measures do not pertain to the time period that followed the introduction of the pension reforms in these countries. But even if such data were available, it would still not provide conclusive evidence, since the time lagged between a reform and its effects need also be taken into account. Such lagged data would not be available for some time in the distant future. But what the data do show is that historically these countries clustered together and it seems likely that these historic trends continue to have effects, even after the marketization of the pension reforms in Sweden and Denmark.

We conclude with a speculative argument about where our analysis leads. We think it is plausible that outcomes were probably similar in all three countries to

*Table 7.4* Total disposable income by deciles: retired population (share of total income, in percentages)

	<i>3 bottom deciles</i>	<i>4 middle deciles</i>	<i>3 top deciles</i>
Denmark 1994	19.7	35.5	44.8
Variation 1983–1994	+1.6	+0.2	–1.8
Netherlands 1995	18.8	34.6	46.7
Variation 1985–1994	+0.3	+0.2	+0.5
Sweden 1995	19.9	36.5	43.5
Variation 1983–1995	–0.5	–0.1	+0.6

Source: Whiteford (2002).



*Figure 7.1* Pension income (public and/or supplementary pension) in the age group 65–69 compared to household income in the age group 20–54, by poverty rates for the age-group 65+ (source: LIS, own calculation).

begin with, and this implies that if some form of solidarity was pursued early on, whether public or private, outcomes were bound to be similar many decades later. To be more concrete: at the end of the nineteenth and the beginning of the twentieth century, the Dutch, Danish and Swedish societies were arguably fairly similar in terms of poverty rates and income distribution. And all three countries, as we document, introduce some form of old-age protection at a fairly early stage. These early arrangements were the edifice upon which later modifications were added, and the solidaristic elements built into these early systems would have important implications for the subsequent development of pension policy, whether it was publicly dominated as in Sweden, or a mix of public and private solidarity as in Denmark and the Netherlands.

This speculative argument brings us to our final point, which concerns the implications of our analysis for the welfare state and path-dependence/institutional change literature. Our analysis shows very clearly that incremental policy changes and even non-action can have dramatic long-term effects. The Dutch and Danes did not set out deliberately to construct a robust public-private mix with elements of solidarity in both pillars. Nor did the Swedes intend to create a public pension scheme with design flaws that only became apparent in the 1980s and 1990s (see Anderson 2005). If we search for 'historical choice points' or critical junctures in all three countries, we are not likely to find them (except perhaps the adoption of ATP in Sweden in 1956). Instead, policy development in all three countries is marked by gradual, incremental change and the absence of episodes of significant innovation (again Sweden is somewhat of an exception). These findings are consistent with the emerging literature on institutional change (Thelen 2004; Thelen and Streeck 2005) that focuses less on institutional stability, and more on the sources of institutional change. According to Thelen (2004) institutional designers cannot control their own creations. Moreover, institutions like pension schemes are almost always the result of political compromises. Thus the key to understanding institutional stability and change is to investigate the political coalitions that sustain institutions. Processes of political bargaining and conflict between political actors with a stake in existing institutions are the sources of institutional change, and these change processes are often long-term.

## Notes

- 1 The basic pension amount is DKK 49,560 and the supplement is DKK 49,140. The pension is reduced by 30 per cent for incomes above DKK 210,600 and the supplement is reduced by 30 per cent for incomes above 46,400.
- 2 Andersen and Larsen (2002), Table 2, p. 16, reported as an estimate of the Danish Economic Council from 1998.

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## 8 The Anglo-American pension regime

### Failures of the divided welfare state

*Robin Blackburn*

The European retreat from public insurance of the risks of the ageing society has been registered in a thorough report submitted by the European Commission and its Economic Policy Committee in February 2006. Looking ahead to 2030 and 2050 the report predicts a declining ‘benefit ratio’, that is a decline in the ratio of per capita pension benefits to per capita output. Indeed, in GDP terms public pension income per aged citizen is expected to drop year by year until by 2050 it will be only a little over half its level in 2004. In absolute terms public spending on old-age pensions, elder care and health is set to grow very modestly at a time when the absolute and relative numbers of the aged are set to rise steeply. In the ‘old’ Europe of the 15 pre-enlargement states, public pension spending as a proportion of GDP is now set to rise from 10.8 per cent of GDP in 2004, to 12.3 per cent in 2030 and to 12.9 per cent in 2050. Over this time the numbers of those over 65 will grow from 65.2 million in 2004 to 114.2 million by 2050, while the total population declines slightly. The elderly population will nearly double in size but the average public pension received will, in GDP terms, drop by more than 40 per cent. The EU-wide projections, covering 25 countries and some 450 million people, are quite similar, with overall public pension spending growing even more slowly despite a rapidly increasing aged population (EPC and EC 2006: 11, 33, 71). Most of the new member states switched from public to private provision with haste and the portents, so far, are not good.

Pension systems have to prove themselves over several decades. However commercial pension systems are as old as, if not older than, public systems. The ‘Anglo-Saxon’ model of publicly-subsidized commercial pension provision already has a long track-record in the US and the UK which I will be examining in this chapter. It has delivered satisfactory results for some, especially those paying the top rates of tax. But for the majority of employees, let alone citizens, the record is an ominous one.

Europe’s pension arrangements needed reform, with more diversified sources of revenue, and some equitable adjustment of entitlements.<sup>1</sup> But in societies where the over-65s will comprise at least a quarter of the population or more by 2030 or 2050, pensioner income will need to command around 16–18 per cent of GDP if the aged are not to fall far behind the prosperity of their fellow citizens.<sup>2</sup> The European governments that have cut back on public pension provision are

hoping that private pensions and savings will cover the gap. Voluntary private pensions lead to very patchy coverage yet governments are often unwilling to compel their citizens to hand over their contributions to private suppliers; Sweden is an exception but a public body organizes the contributions and establishes a ceiling on charges that is unpopular with suppliers. The financial services industry much prefers a voluntary system with a large public subsidy and so far most European politicians appear to be moving in this direction.

### **Pension shortfalls in the US and UK**

In the US and the UK very generous tax breaks have long been given to the financial services industry in order to encourage it to supply old-age pensions. By 2004 the breaks to private providers cost the US Treasury over \$120 billion a year in lost taxes (more than five times the size of farm subsidies); in the UK such tax concessions cost £19 billion annually, a figure that reduces to a net £13 billion if we take account of taxes that will eventually be paid once the pension income is received. In the US employers can also offset health insurance for their employees against tax. Jacob Hacker has pointed out that the result has been a 'divided welfare state' that absorbs almost as much public revenue as the historic welfare arrangements of Germany and France (Hacker 2002: 93–95, 149–50, 161–162, 185, 294–295). Unfortunately such arrangements are both less efficient and less egalitarian. The public subsidy of private provision produces results that are mediocre or worse, whether we look at delivery, coverage, the impact on savings rates or projected future GDP going to those past retirement age. The US defined-contribution (DC) schemes – the employer-organized 401(k)s and the Individual Retirement Accounts (IRAs) – have grown rapidly over the last two or three decades but only cover a little more than half the population, with that coverage in some cases being minimal, as we will see. The eventual pensions generated by these savings are most unlikely to make up for the decline in occupational defined-benefit (DB) schemes. Many of these are more than half a century old, and are now bedevilled with deficits, leading large numbers of employers to close them.

The US Social Security programme only claims to furnish a basic pension yet it is the most important source of retirement income for more than 60 per cent of senior citizens. Projections for 2030 show Social Security supplying old-age pensions worth over 5 per cent of GDP while private pensions of all types are unlikely to supply as much as 3 per cent of GDP (Board of Trustees 2005). Indeed, even adding in the pensions of public sector workers and the earnings of those past retirement age, the total incomes of those over 65 are on course to fall short by 4 per cent of GDP of what would be needed to maintain relative pensioner incomes (Blackburn 2007).

The UK has weaker public pensions provision than the US. Its Basic State Pension replaces only about 14 per cent of average earnings; the supplementary, means-tested Pension Credit brought the pension received by those with no other coverage up to £109 a week in 2005. Long-established private and occupa-



tional pensions have delivered good results to the richest tenth of employees, and some civil servants. The Labour government sought to widen coverage with its Stakeholder pension in 1999 but this failed to take off, partly because the suppliers did not like its cap on charges. The first report of the government's Pension Commission in 2004 identified a huge savings shortfall, affecting eight million people on low and medium incomes, with women being particularly at risk. It forecasted that public and private pensions together would miss the target by around 4 per cent of GDP, that target being what would be needed to maintain the relationship between pension incomes and average income.<sup>3</sup> In the US the commercially successful 401(k) or IRA schemes only cover about one-half of the working population, and many of those, with nominal coverage, will benefit little, as we will see. So the growth of these relatively new types of DC pension does not compensate for the slow but relentless decline of traditional DB coverage. Nevertheless official pension policy still sets store by new pension products and new ways of supposedly insuring existing occupational schemes. Such forecasts suggest that in the realm of pension provision the 'Anglo-Saxon' model is not worthy of emulation. They also pose the question of why the Anglo-American divided welfare state is so bad at converting contributions into pensions. In what follows I offer an examination of the true extent and roots of these failures.

A major study of the pension assets of US employees by Edward Wolff, of New York University, found that, already in 1998, with a still buoyant stock market, the prevailing pension regime – with its heavy reliance on, and subsidy of, commercial provision – was failing. It found that 18.5 per cent of households heading for retirement could expect incomes below the poverty line while 42.5 per cent would not be able to replace 50 per cent of their pre-retirement income (Wolff 2002). Wolff also traced the remorseless decline of the income of the median household – that is the household at the mid point in the distribution – at successive ages after 47–52 (Table 8.1). This toboggan slide shows that retirement income suffers steady erosion because most of it is not very well protected from inflation. The figures are for 1998 so those for older ages will also reflect weak coverage in the past. Figures for 1983 and 1989 showed a very similar steep decline.

*Table 8.1* The decline of income after 52 years of age in the United States

<i>Age of main recipient</i>	<i>Median household income (\$ a year)</i>
47 to 52	49,000
53 to 58	43,000
59 to 64	35,000
65 to 70	26,000
71 to 76	21,000
77 and above	16,000

Source: Wolff (2002: 65).

A follow-up study by the same researcher, 'The unravelling of the American pension system, 1983–2001', took the story up to 2001. It found that despite a huge savings effort, and a big jump in share prices, the majority of US employees were little better off in 2001 than they had been in 1983. It also found that 'pension wealth inequality grew sharply as well. In fact counting total wealth (including pensions), the average household was somewhat worse off in 2001 than in 1983' (Wolff 2004: 3, 18). Wolff found that the proportion of households where at least one member had a DB pension plan fell from 69 per cent to 45 per cent between these years, while the proportion with a DC plan rose from 12 per cent to 62 per cent. Overall, 'private accumulation' (the sum of net worth and pension wealth) fell by 2 per cent. The implication of these figures is that the US had a very inefficient savings system. As we will see below this inefficiency relates more to exorbitant costs than to rocky stock markets, though the latter certainly takes its toll.

Wolff's studies revealed the weakness of today's and tomorrow's pension assets in the world's largest and richest economy – and in a society that greatly relied on private retirement provision. They did not seek to capture the prospects of pensioners the *day after tomorrow*, which now appears likely to be much worse. In this context the day after tomorrow may be 2030 or 2020 or it may be sooner than that. The years after 2001 brought more 'unravelling', as DB sponsors reneged on their promises, DC plans wilted and more households faced poverty in retirement. A 2003 study of pension adequacy by the Employee Benefit Research Institute added projected future income from occupational schemes and personal plans to Social Security entitlements. It concluded:

America's elderly face an income shortfall between 2020 and 2030 of at least \$400 billion – including at least \$45 billion in 2030 alone – just in their ability to cover basic living expenses and any expense associated with care in a nursing home or from a home health care provider.

(Van Derhei and Copeland 2003: 1)

Robert Reynolds of Fidelity concurred, writing: 'By 2030, the system is on track to provide low income workers with only about a quarter of their pre-retirement incomes' (Reynolds 2005). This disturbing conclusion – 25 per cent of a 'low income' is a real pittance – was not much alleviated by his further observation that: 'This "replacement rate" does rise to 56 per cent for the most highly-paid workers' (Reynolds 2005).

British data tell a similar story. A study focused on those aged 50 to 64 in 2002 found that one-half of this group were in households that had pension resources and entitlements ('pension wealth') that would yield an income of less than £11,000 a year from all sources. The cohort selected should be among the best provided for, having had a long accumulation period in relatively benign economic conditions and with prospects buoyed by the fact that they are close to peak earnings. While this is certainly the case with the upper deciles the overall picture is quite polarized. A couple with the indicated level of income would be

just above the poverty line, defined as 60 per cent of median income. A quarter of this age group had no private or occupational coverage at all. The UK's very modest state pension comprised more than half of all income for the poorer half, that is the bottom five deciles, and was the major source of pension income for the bottom seven deciles. Overall the state pension comprised 35.2 per cent of all pension wealth, with current DB pensions supplying 30 per cent and current DC pension plans accounting for only 7.4 per cent of pension wealth, despite the fact that 33 per cent of men and 20 per cent of women had such plans. Just over a quarter of pension wealth came from 'past pensions', most of which were also DB schemes, some already paying a pension and disproportionately benefiting the top deciles. Women's pay lags men's pay by 17 per cent in the UK and expected pension income in retirement closely reflects this inequality with 26 per cent of both sexes receiving a pension that is less than 50 per cent of their former income, a further 23 per cent receiving between one-half and two-thirds of their former income and 50 per cent receiving over 67 per cent (Banks *et al.* 2005: 18, 25).

While state pension entitlements are fairly evenly distributed, private pension wealth is very unequally distributed, and is highly correlated with non-pension wealth. The richest tenth of this cohort approaching retirement had pension wealth and overall wealth that was more than twice as great as the next decile. The members of this richest decile had a mean total wealth of over £1.6 million and pension wealth of around three-quarters of a million pounds. The researchers add a note explaining: 'the mean levels of each form of wealth ... are inflated by a small number of extremely wealthy individuals (about the top one per cent of the whole distribution)' (Banks *et al.* 2005: 31). However they add that even excluding such individuals the richest tenth do very well. The fact that one-half of UK tax relief goes to the richest tenth of households helps to explain their impressive accumulation of pension wealth. But the benefits of the now-threatened (or even disappearing) DB approach to occupational pension provision, and the meagre contribution made by the so-called DC schemes, also make a striking contrast.

By 2005, the Anglo-Saxon pension regime was in deep trouble on both sides of the Atlantic. Addressing the long-term impact of crumbling occupational schemes, weak securities markets and exorbitant costs resembled trying to measure the melt-down of a glacier in a heat wave. Pension promises – solemn contracts that helped to constitute the 'pension wealth' which Edward Wolff already found inadequate in 2001 – were seemingly there to be broken.

### **'Defined-contribution' plans as leaky buckets**

Employers in the US and UK now much prefer DC schemes because they eliminate a future risk, and allow them to fix and reduce their contribution. Employees may grumble but the DC scheme is portable while most corporate DB accounts are not. In the DC scheme the future pension will be simply whatever the accumulated sum in the fund will purchase at retirement, with no link to

final salary. While some large employers operate their own DC scheme others make available a menu of savings options offered by the large commercial suppliers. In the US the tax-favoured 401(k) envelope has attracted a huge inflow over a period of two decades – 401(k) being the relevant US tax code reference. The UK has had a succession of tax-favoured savings schemes since Gladstone's 1853 budget but until the introduction of the Stakeholder Pension in 1999 employers were not obliged to offer them to all employees. Yet neither in the UK nor in the US has employer provision solved the besetting problems of DC schemes, namely uneven coverage, high charges and weak employer commitment.

The employer who sponsors a 401(k) makes no commitment to guarantee its value and has transferred all market risk to the employee. The employee has a 'portable' pension fund, free of sponsor risk. The advantages to employers and employees alike led to the numbers of those with 401(k)s rising from zero in 1980 to over 55 million by 2005. But charges are high and their prospects as a retirement vehicle reduced by the fact that holders of 401(k)s can make draw-downs from their accounts prior to retirement if they get into difficulties. High charges also drag down the rate of return achieved by those who establish an IRA with the commercial supplier of their choice. And, once again, the individual bears the market risk. Moreover he or she does so without being able to draw on the type of risk-pooling which allows those who die earlier to subsidize those who live into their nineties. Because women have longer life expectancies than men they suffer more from this constraint on risk-pooling. Where a good annuity can be purchased on retirement some risk-pooling can be achieved but good annuity products are very difficult to find in the US and are becoming rarer in the UK as well. Partly this is because of the decline in long-term interest rates, but it is also because suppliers do not like being exposed to 'adverse selection'. Unless the purchase of an annuity on retirement is compulsory, those taking up the option are thought likely to have better insight into their probable life expectancy than the supplier. Whatever their weaknesses the traditional DB schemes at least embodied the risk-pooling of classic insurance principles. As we will see below, the annuity problem is just one reason why the transition from DB to DC will show up in two or three decades time as a rise in pensioner poverty.

If pension coverage is to be effective it should move away from, not towards, the commercial and individualized form. Pension provision is a field where commercial provision has been tested and found wanting. After nearly 50 years during which more than half the working population has paid into such schemes – and during which they enjoyed, as we have seen, vast subsidies – the modest (US), or miserly (UK), public old-age pension is still the most important source of income for 60 per cent of those in retirement in those countries. One reason for the comparative success of the public systems in generating incomes from contributions is that *their costs are low*. There is no expensive customization and marketing. Contributions are handled as part of payroll and the public employees who administer the schemes do not earn the exaggerated salaries of

those in the financial sector. The *longevity of the public provider* is also an asset. As people are urged to insure themselves against the major risks of life by applying to commercial organizations we should recall Richard Titmuss's famous observation that while we can be fairly confident that there will be a government of some sort in 50 years time we cannot say the same about any particular company or financial provider. Even the most up-to-date and glamorous corporation can collapse, as Enron's employees and investors, including many pension funds, discovered in 2001. Likewise, even the oldest and most respectable financial house can be obliged to close its door, as nearly a million policyholders with Britain's venerable Equitable Life (founded in 1762), discovered to their cost around the same time.

During the boom years of the 1980s and 1990s many of those paying into private pension schemes did quite well. Awareness of this fact has encouraged those with scheme membership, or the beginnings of a pension pot, to bask in unwarranted optimism. Even in the heyday of booming exchanges, plan charges still absorbed much of the generous tax subsidy. During three years of negative returns in the stock markets in 2000–2002 the high charges were still there but not the high returns to cover them. US fund values fell by about one-half over these three years. The millions who reached retirement age at this time, or were forced into early retirement, paid a stiff price for the market slide. Even the more comfortable holders of 401(k)s, the most widespread savings vehicle, mournfully quipped that they had turned into 201(k)s. The subsequent stock market recovery ran out of momentum before many stocks had recovered their previous levels. The bubble and its aftermath leave a long shadow and it will require a very strong and sustained recovery to repair the damage.

The wealthier holders of 401(k)s and IRAs did very well out of hedge funds in the 'roaring nineties' and often quite reasonably in later years. This is because they were able – up to stipulated income limits – to claim back higher rate income tax at 35 per cent or more, and because the size of their portfolio spread the cost of management charges, so that they were lower as a proportion of the fund value. In the US the richest 10 per cent of tax payers received 62 per cent of the tax relief granted on pension and health coverage in 1988 while in the UK the corresponding figure was 51 per cent in 1996 (Hughes and Sinfield 2004: 171). The subsequent lowering of the top US rate of tax will still leave the top 10 per cent of tax payers sitting on their past gains and claiming rebates worth around \$60 billion a year, while their UK counterparts do likewise and pocket over £6 billion of foregone taxes annually.

But for the majority of US employees their 401(k) savings have furnished a poor return because of heavy administrative and marketing charges. One source of high charges is the fragmentation and proliferation of small schemes. *The Wall Street Journal* reports an industry survey which found that:

Investors in 50-person plans pay an average of 1.4 per cent of their assets in fees or about \$14 for every thousand dollars invested – assuming an average participant balance of \$40,000 – according to a new study by HR

Investment Consultants in Baltimore. That compares with 1.17 per cent for investors in 1,000-person plans. But investors in small plans pay as much as 4 per cent or more according to HR. That could mean a significant difference to participants over time. Over twenty years, a 1 per cent increase in fees on a \$100,000 investment can reduce the portfolio's ultimate gain by \$66,254, assuming annual investment returns of 7 per cent. And fees can take a particularly large bite out of an investors annual return when investment returns are low.

(Oster and Damato 2004)

According to this report of the 400,000 companies with 401(k) plans nearly three-quarters are plans with fewer than 50 members. These small-company sponsored plans hold a total of \$192 billion of assets in 2004, which would generate annual management fees totalling \$8 billion or more at the indicated expense ratios.

A major source of high charges is intense competition for business. The employers, who have their own businesses to run, are likely to think they have done their duty by their employees if they selected a well-known supplier. Almost without exception the better-known suppliers are those who advertise a lot. They do so, first, to promote their brand, and, second, to promote particular funds. Most suppliers maintain scores of funds with somewhat varying strategies. On the one hand they can cater to different investment styles and, on the other, their range of funds should have some with above average performance to brag about. A company that spends a lot on its brand is sometimes said to be signalling confidence in its product to consumers, but multiple product lines and lengthy maturation periods mean that the signal is very misleading in this case. A further complication is the cost of exit and the dearth of alternatives.

DB schemes, being occupational, incur little or no marketing charge, and have administrative costs of 0.5 per cent or less of the fund each year, DC schemes typically incur costs of at least an additional 1 or 2 per cent of fund value each year. E. Philip Davis, author of an authoritative study of pension funds, explains that 'personal defined-contribution plans are particularly vulnerable to agency problems vis-à-vis financial intermediaries' (Davis 1995: 236). The financial suppliers have the upper hand, in his view, because of 'the information asymmetry between seller and buyer, the one-off nature of the transaction, and the lack of purchasing power of the purchaser ... as well as the ability of the seller to impose high commissions on the purchaser' (Davis 1995: 236). He added that 'there are also economic reasons for high costs, such as the need to construct individual contracts, as well as the need for expenditure on advertising, marketing and public relations' (Davis 1995: 236).

In *Banking on Death* I cited a host of studies conducted in the 1980s and 1990s showing reductions in yield on DC plans of between 20 and 55 per cent (Blackburn 2002: ch. 2). In 2001 two *Business Week* journalists published a book entitled *The Great 401(k) Hoax* which highlighted their dismal performance during the great bull market (Wolman and Colamosca 2001). Two former

Treasury officers reached the same conclusion in a book published the following year, entitled *The Great Mutual Fund Trap* (Baer and Gensher 2000). In an autobiography published in 2002 Arthur Levitt, the former chairman of the Securities and Exchange Commission (SEC), spent two dozen pages itemizing 'The seven deadly sins of mutual funds', recounting his failure to prevail over the formidable lobbying power of the financial services industry (Levitt 2002: 41–64). An even more devastating indictment of the industry appeared in 2005 when John Bogle published *The Battle for the Soul of Capitalism*. Bogle is the founder and former CEO of the Vanguard group, the only major fund group to be organized on non-commercial, genuinely 'mutual' principles, with no shareholders. As an insider, and rival of the commercial suppliers, Bogle knows where the bodies are buried. He points out that while total assets of the equity funds run by the money managers grew from \$2.5 billion in 1950 to \$4,034.5 billion in 2004, expenses grew from \$15.2 million to \$37,117 million. In other words assets multiplied by 1,595 while expenses multiplied by 2,445. This might look quite bad but Bogle supplies a further breakdown. He points out that from 1945 to 1960 charges fell as managers achieved economies of scale and passed along the savings to customers. But since 1960 the movement has been very much the other way: with the industry leaders raising average annual ratio of assets to charges by 169 per cent (Bogle 2005: 154–155). However he urges that it is misleading to measure charges as a percentage of assets and himself prefers to specify their total in dollars and to measure these against dividends earned by the fund assets:

Tiny numbers like 0.92 per cent or even 1.56 per cent [these were the industry's total weighted and unweighted expense to asset ratios in 2004] seem relatively trivial. Yet when we examine expenses as a percentage of a fund's dividend income ... the numbers take on a more ominous cast. Indeed with today's yield on stocks at about 1.8 per cent, a typical 1.5 per cent equity fund expense ratio consumes fully 80 per cent of a fund's income.

(Bogle 2005: 156)

In better years an equity fund might earn a total return – including capital gains – of 6 per cent so the expense ratio would be 25 per cent, still a hefty cut.

The employers' contributions to DC funds often have 'vesting' conditions which mean that they are worthless unless the employee stays with the company for, say, five years, or reaches the age of 50. It is also common practice, notwithstanding its notoriety at the time of the Enron collapse, for the employers' contribution to take the form of company shares. While it is easier for employers to issue new stock than pay cash, it concentrates the employee's risk. A survey of one and a half million 401(k) plans by Hewitt Associates showed that 28 per cent of their assets at the end of 2002 were shares in the employer's stock (Morgenson 2003). With the collapse of the share bubble fund values dropped by nearly a half over the three years following March 2000. In 2001, at midpoint in



the decline, 42 million savers held a total of \$1.8 trillion in their 401(k) accounts. The average holding was around \$50,000, but, as we have seen, 42 per cent held less than \$10,000 (Levitt 2002: 257). While new accounts are bound to be small at least three-quarters of these micro-accounts were depleted because of collapsing stock prices and/or emergency draw-downs. Holders of 401(k)s and IRAs bear all the market risk. They lose if they sell when the market is down, and pay a charge if they transfer funds to a new scheme.

Many suspect they don't get a good deal from the fund managers and everyone knows that the stock market is risky. The historic rationale for DB funds was their greater security and cost-effectiveness. But, of late, the apparently greater certainty of these schemes has too often turned out to be an illusion and a trap.

### **The agony of 'defined-benefit'**

Those who belonged to the DB schemes, the classic mid- and late-twentieth century occupational arrangement, generally did quite well if they retired before the dawn of the twenty-first century. Employers saw these schemes as a good way to attract and keep the best workers. They were offered to individual employees but also loomed large in negotiations with unions. They were thought to be the 'gold standard' of retirement coverage. Following legislation in 1974 – the Employee Retirement Income Security Act (ERISA) – the future benefits they offered seemed assured. ERISA established the Pension Benefit Guaranty Corporation (PBGC), an insurance scheme to which all corporations running DB schemes had to belong. At their high point, in the early 1980s, the majority of workers belonged to such schemes but they became unpopular with some managers and many shareholders as it became clear that the new arrangements could erode shareholder value. The total number of such plans offered by corporations declined, from 112,200 in 1985 to 29,700 in 2005 (Pension Benefit Guaranty Corporation 2004: 14; Bartlett and Steele 2005). The regulated pension regime was more onerous for employers, with mandatory disclosure and contributions. The quest for maximum shareholder value was stimulated by take-overs, mergers, bankruptcies and successful attempts by employers and investors to avoid pension obligations that would weigh on the balance sheet. In the early days future pension obligations did not figure in the main accounts. By the 1980s regulators and investors took a keen interest in pension disclosure. During the share boom boards were happy to oblige as pension fund gains could be used to strengthen the bottom line. But the collapse of the share bubble in 2000 and after revealed large deficits. Corporations also found retiree healthcare benefits an increasingly awkward burden, withdrawing them where they could. The number of large companies offering such benefits dropped from 66 per cent to 36 per cent between 1988 and 2004 according to the Kaiser Family Foundation.<sup>4</sup>

Notwithstanding plan closures, the remaining DB schemes still had large assets and a rising number of participants, that is retirees and contributing employees. At the end of 2004 DB funds in the US held \$3.8 trillion of assets up



from \$1.7 trillion in 1990. The DB form is widespread in the public sector and DB funds in this sector held \$2 trillion of assets in 2004 compared with 0.8 trillion in 1990. The total number of participants in private sector plans has continued to grow even while the number of those plans had dropped. At the end of 2004 there were 44.4 million participants in private sector schemes, over a half of them now retired and drawing pensions. Though many have been closed or frozen the process takes a long time to complete because of obligations already incurred. A 'closed' scheme is closed to new members, but existing members continue to build their entitlement. In a 'frozen' scheme existing entitlements are preserved but can no longer be built upon. Someone who was part of such a scheme from 1980–2000 may have 20 years to go before they can claim a pension and will then draw it for 25 years, so the frozen scheme should still be active for half a century. And, of course, there are still successful companies, with well-funded schemes, who remain true to their promises. Assuming no legislative or economic earthquake – as we will see below these systems are built on a fault-line so this would be optimistic – paying out pensions will eventually run down the size of such funds and death will eventually reduce their participant numbers. The members of these schemes will still be able to claim a pay-related pension but if they have left the sponsoring company ten or 20 years before retiring, the pension they get will lose value because it will reflect neither seniority nor promotion.<sup>5</sup>

Despite their supposed statutory protection, the recent vicissitudes of DB schemes show them to be vulnerable to employer negligence or even deliberate sabotage. The funding formula laid down by the PBGC and the Federal Accounting Standards Board (FASB) made it too easy for the employer to skip contributions. During the boom years of the business cycle employers can take contribution holidays – GE went for 13 years in the 1980s and 1990s without making any contribution to its pension fund. Over these years many steel companies, telecom operators, airlines and auto companies also skipped contributions or minimized them by means of unrealistic accounting. United Airlines made no cash contributions to any of its four employee plans between 1996 and 2002, years when the fragile condition of the company should have made this a priority. When the PBGC took over its liabilities in 2005 the schemes were found to be under-funded by \$1.4 billion (Lowenstein 2004; Schroeder 2005b). British legislation stipulated a target amount for contributions but also allowed this to be offset against any rise in the value of the pension fund. In 2003 the Inland Revenue calculated that UK companies subsequently found to be running a deficit skipped contributions worth £27 billion between 1988 and 2001.

At many leading companies the company pension fund long ago grew to be worth more than the company itself. Indeed at such companies as Boeing, Ford, General Motors or Colgate/Palmolive in the US, or BT, GKN or Unilever in the UK, the pension fund was worth several times the equity valuation of the sponsor by 2000, if not long before. Financial analysts began to describe GM as a hedge fund on wheels and United Airlines as a pension fund with wings (of lead as it turned out). Companies that had happily booked pension fund

surpluses as profit, encountered a more awkward logic when the stock markets slumped. Because the company stands as guarantor to the DB pension fund it has to make good any shortfall that may arise. Matters can be disguised by fancy accounting but following the collapse of Enron and Andersen, and the advent of tougher reporting standards, auditors became less inclined to indulge their clients' wishful thinking. Once under-funding is admitted the corporation has to put in place a programme of payments to restore its solvency, with results that weaken earnings or investment or both. At the end of 2002 the majority of corporations in the Standard & Poor 500 in the US and FTSE 100 in the UK had under-funded pension schemes, with the total deficit being around \$300 billion in the US and, supposedly, £55 billion in the UK.

The overall pension deficit continued to grow in both the US and the UK during the modest recovery of the years 2002–2005, because of the difficulty of making up for three lost years and because of accountants' greater stringency. In October 2003, after a sustained share rally, the director of the PBGC told the US Congress that the corporate pension fund deficit stood at about \$350 billion (Cohen 2003a, 2003b). By mid-2005 the PBGC estimate put the corporate pension fund deficit at no less than \$450 billion. Deficits relating to 'other post-employment benefits', mainly retiree healthcare coverage, ran at an extra \$300 million (*The Economist* 2005). In the UK a newly established Pension Protection Fund (PPF) estimated the shortfall in DB private sector schemes in June 2005 to be £134 billion (*The Economist* 2005).

The calculation of the estimated deficit is sensitive to discounting assumptions. If a higher discount rate is employed then it will produce a lower 'present value' of the future pension obligation, making deficits more likely and higher. The FASB and PBGC had traditionally prescribed a rate of interest that would be 85 per cent of the rate on 30-year Treasury bonds, the rationale being that the return on a safe asset was the right match for pension saving. But in 2003 this was changed by Congress to the full T-bond rate and then, in 2004, to 85 per cent of good corporate bonds, raising the discount rate still further. Chief Financial Officers (CFOs) could now discount their obligations by nearly 5 per cent annually instead of by less than 3 per cent (Pension Benefit Guaranty Corporation 2004: 15). Special legislation allowed airline companies even easier calculations. While Congress was indulging corporate fantasy by notionally shrinking their pension obligations, many corporations were helping themselves, by similar means, to inflate the future value of their fund assets. Despite three dreadful years on Wall Street CFOs were still blithely anticipating long-term rates of return on their pension fund holdings of 8, 9, or even 10 per cent annually. Though the SEC was to investigate some egregious cases of make-believe, blind optimism was often indulged by regulators and legislators alike because of the implications for jobs.

The accounting rules governing corporate sponsors allow them both to bring in the income of their pension funds and to engage in legal 'smoothing' of their overall earnings. A study of 3,000 companies over 11 years undertaken at Harvard Business School and MIT is reported to conclude:

companies tended to ratchet up their assumption of pension fund returns, padding their profits just before certain corporate events, like acquisitions, secondary stock offerings or the exercise of stock options by executives – all times when a higher stock price is desirable.

(Williams Walsh 2005b)<sup>6</sup>

David Zion, an analyst with Credit Suisse First Boston, investigated the reported earnings of all companies in the Standard and Poor top 500 with a DB fund in the years 1999–2003 and showed the widespread use of phantom pension fund earnings to conceal real losses. The CFOs were permitted to come up with a figure for anticipated pension fund earnings at the beginning of the year and then to book those earnings at the year's close even if the real performance had been much worse. Zion likened this practice to 'depositing a paycheck for what you think you should be paid instead of what you were actually paid' (Williams Walsh 2005b). The result was to raise aggregate earnings of these companies from \$73 to \$221 billion in 2002, and from \$81 to \$247 billion in 2002. At many companies the changes made the difference between a profit and a loss: in 2003 Fedex reported profit of \$830 million but with pension fund earnings stripped out this became a loss of \$87 million while at Boeing the same procedure turned a \$713 million profit into a \$158 million loss (Williams Walsh 2005b).

There is such latitude for make-believe in corporate pension funding that it is easy to come away with the idea that fund liabilities are infinitely malleable. But that is not the case. This is partly because employees do eventually retire and must be paid their pension. It is also because of the increasing nervousness of accountants, regulators and shareholders. Pension obligations have a contractual force that cannot be magicked away by fancy accounting, or the fiat of a CFO. On the other hand, and partly in consequence, DB pension entitlements remain very vulnerable – corporate leaders come to hate them, and are willing to consider almost any desperate expedient if it promises relief from the nightmare of pension liabilities. Theoretically legislators could openly tear up the pension contract, declaring it null and void. In practice this is most unlikely because it would be too unpopular and because there are less blatant ways of achieving the same result – encouraging workers to agree to 'give backs' in order to save their job. The threat of bankruptcy has come to haunt many large sponsors. While threats sometimes suffice real liquidations are messy and costly, removing employee entitlements but involving real losses and risks for the existing managers and owners. A bankrupt company can shed pension obligations but many existing owners and managers find such a cure worse than the disease, with the former losing value and the latter their jobs. So some corporate managers decide to reduce their pension deficits by giving this a belated priority and seriously paying down their deficit. In the UK the introduction of more stringent rules for calculating pension fund deficits – FRS 17 – led companies to pay £25 billion in contributions to their DB pension funds in 2004, twice what they had contributed in the previous year (*The Economist* 2005).

## **Jobs versus pensions**

Paying down a pension deficit can hurt employment. It leads companies to avoid hiring and shed labour. Accounting practice confers an extra bonus for the balance sheet. Every worker off the books means that the accountants henceforth only need to count the ABO (Accrued Benefit Obligation) rather than the PBO (Projected Benefit Obligation). Because the ABO does not incorporate future raises and seniority, it is generally only about two thirds of the PBO. So a policy of firing workers helps the employer in two ways; it reduces current outlays and it reduces future liabilities. This logic helps to explain why about 2.8 million workers lost their jobs in the US in 2000 to 2003.<sup>7</sup> In the UK the manufacturing industry lost jobs at the rate of 5,000 a week in 2002–2004 but overall employment remained high thanks to the creation of hundreds of thousands of jobs in the public sector. While the overdue rehabilitation of public services was welcome the losses to manufacturing are likely to be permanent.

The conjuncture of 2001–2003 echoed that of the early 1990s when an orgy of downsizing – especially at DB-sponsoring companies like the US steel corporations – put hundreds of thousands on the scrapheap with a reduced pension. ‘Pension deficit disorder’ thus contributed to the debility of US and UK manufacturing since enterprises in this sector typically had mature DB schemes and often found themselves starved of funds just when investment should have been boosted. The logic of DB funding was ‘pro-cyclical’, encouraging weak contributions during the good years (because the fund goes up anyway) but helping to accentuate job loss in a recession, and to slow recovery thereafter. For some time joblessness has been lower in the US and UK than in continental Europe but its composition is different. In Europe employers were discouraged from creating low paid service jobs by weak demand and high payroll taxes, even though they were allowed to put some of the latter into company reserves. But strong manufacturing concerns – with strong productivity and reserves accumulated in the good times – were able to sustain the sort of permanent, skilled employment which was destroyed by the ‘Anglo-Saxon’ pension regime.

The basic design flaw in the DB schemes is that they carry the guarantee of a single corporate sponsor. Over the three or four decades it takes for a pension scheme to mature the sponsor can go from being a blue chip to a basket case. Comparing the US or UK stock exchange stars of the 1950s, or even the 1970s, with those of 2005, the overlap is small. The oil companies, the banks, and GE, still loom large in the NYSE but much else has changed – Microsoft, Walmart, Intel, Google, and eBay are quite new. IBM and Coca-Cola are still there but have shrunk in size. The UK FTSE 100 is likewise dominated by newcomers like Vodafone while famous names like ICI, Marconi and Unilever are shadows of their former selves. In this changeable corporate environment it would have made far more sense to have a multi-employer structure to guarantee pension provision. In Europe – and beneath the surface in the US too – many large employers understood this and supported state-sponsored collective provision in the inter-war period (Sweden) or post-war period (Germany and France)

(Swenson 2003). Given the huge pressure of healthcare and pension costs on US employers evident by 2005 it is interesting to find that when Toyota announced plans to invest in North America in that year it opted to establish production in Canada because of its more collectivized healthcare and pension arrangements. The employee gains security and is also able more easily to move from one employer to another, something the good employer does not have to worry about. Presumably Toyota sees itself as a premium employer, without need of pension handcuffs.

### **Feeble insurance and ‘vulture capitalists’**

In the US the ERISA legislation of 1974 set up the PBGC, a non-governmental entity to furnish a measure of insurance to the DB schemes. In case of default beneficiaries generally get about 75 per cent of their pension and none of their retiree healthcare benefit. Corporations have to pay an annual premium calibrated according to the size of their liabilities. So long as the company remains solvent it cannot invoke the insurance so scheme members expectations of full benefit are still dependent on the fate of a single company. Subject to certain conditions, US companies that enter ‘Chapter 11’ bankruptcy protection can hand over their liabilities to the PBGC, with the latter now becoming responsible for the future payment of reduced-rate benefits. Employers with large obligations have used the threat of receivership to obtain union agreement to benefit cuts and to pressure the PBGC into granting further contribution holidays. The PBGC has proved no better at resisting the extortion than the unions. However much store workers set by their pension entitlement, they need and value their jobs even more. In mid-2003 the PBGC identified chronic pension deficits at 270 large corporations but was itself over \$5 billion in deficit and therefore in no position to alleviate the situation. As companies filed for bankruptcy protection (under ‘Chapter 11’) they called in their insurance coverage and the PBGC was obliged to extend it. Thus in 2001 it took responsibility for Bethlehem Steel’s obligations and in 2005 accepted \$6.6 billion in unfunded liabilities from United Airlines (*The Economist* 2005). The agency’s deficit grew to \$23.5 billion by 2004. The deficit here is the gap between its current assets – over \$39 billion of securities in 2004 – and anticipated income, on the one hand, and the present value of its future liabilities, on the other. While it can expect future income to cover some of the shortfall the sharp rise in its deficit makes a general default all too possible, no doubt triggered by the collapse of a few major schemes. The PBGC is not covered by any Federal guarantee but some suppose that the Treasury would have to step in to prevent actual bankruptcy should that loom.

While an insurance system is certainly needed, that currently offered by the PBGC is neither convincing nor appropriate. UK DB schemes had no insurance available to them at all until 2004, a year marked by some high profile bankruptcies which prompted the government to come up with a remedy. Because of the US agency’s well-advertised difficulties the British government’s Pension Act

of 2004 significantly modified the PBGC model. The UK PPF was to be funded in a way that, it was hoped, would avoid two defects that have shown up at the PBGC, first that companies in difficulties blackmail the agency into forgiving contributions, and second that the very existence of the insurance scheme encourages corporations to award over-generous pensions secure in the knowledge that the insurer would pick up the pieces ('moral hazard' in economists' jargon).<sup>8</sup> The PPF was mandated to rank all participating corporations according to ten degrees of risk and then oblige the more risky to contribute at a higher level. In this way weaker companies would be obliged to contribute more or less. A 2005 bill before the US Senate sought to enable the PBGC to adopt the same approach.

However this tougher species of insurance will further weaken already troubled companies because they will have to pay at the highest rate, subtracting from the resources they need for survival. Awareness of this awkward fact has pushed judges and regulators to an interesting expedient, requiring corporations that have defaulted on contributions to issue shares to the insurer in lieu of cash. As *The Wall Street Journal* reported in November 2005:

The US government is on its way to becoming a big shareholder in the nation's airline industry and possibly in the auto industry. And it is likely to get sizeable chunks of North-west Airlines, Delta Airlines and Delphi Corp. – if as expected, the companies ask the bankruptcy courts to dump their pension plans on the insurer.

(Schroeder 2005a)

In the UK the newly established pensions regulator found himself in exactly the same situation in June 2005 when he allowed the PPF to accept one-third of the shares in a recently reorganized company. He explained his decision by saying that it would both permit the PPF to garner an asset and protect jobs at the company concerned.<sup>9</sup> While there is a strong case for moving to a new system of second pensions which is not company-specific those employees who have already built up entitlements will wish to see them better insured. Allowing an insurer such as the PGGC or PPF to accept shares in lieu of cash could make sense but not confining this policy to weak companies.

The problems of the DB pension schemes have produced a new breed of financier dubbed the 'vulture capitalists'. They specialize in extracting value from firms burdened by large pension and medical liabilities by shedding the latter. Robert S. ('Steve') Miller has appeared on the scene of a string of corporate wrecks. At Chrysler in the 1980s he used threats from the company's creditors and bankers to extract concessions from the unions and the PBGC. As CEO of Bethlehem Steel in 2001 he closed down the company's pension plan, leaving \$3.7 billion of unfunded liabilities to be inherited by the PBGC. Wilbur Ross stepped into to buy Bethlehem and four other dying steel companies, putting them into bankruptcy in order to wind up their pension plans and then selling the newly viable concerns for a profit of \$4.5 billion. The employees, by contrast,



were left with shrunken benefits (Williams Walsh 2005a). In 2005 Ross took over one of GMs major suppliers, Delphi, and is believed to be embarked on a similar exercise in salvaging value in the auto industry. Other financiers who have acquired 'distressed assets', shedding their pension liabilities by means of bankruptcy in order to reap a massive capital gain include Carl C. Icahn (TWA) and Ira Rennert (WCI Steel). In each case it is the PBGC which became the receptacle for the (reduced) pension liabilities.

The PBGC has been an unacknowledged – and largely unrewarded – instrument of industrial reorganization and industrial policy. Partly in consequence its future is in doubt. Further large scale defaults will drag down the PBGC and lead to calls for a Federal bail out. Those who now depend on the PBGC will find their shrunken pensions further reduced and the US tax payer will underwrite the 'barnacle removing' of the distressed assets specialists. The UK's PPF, which opened for business in April 2005, finds itself facing very similar problems. These are disasters waiting to happen.

## **Conclusion**

The Anglo-Saxon commercial pension fund regime, whether DB or DC, fails on many counts. The extent and quality of coverage is poor. Corporate DB schemes are increasingly risky, and can be bad for investment and jobs. Public DB schemes seem to be living on borrowed time. DC schemes are plagued by marketing costs and hidden charges. They are vulnerable to unscrupulous intermediaries, and their flexibility is achieved at too high a cost. They consequently do not build adequate funds or yield good returns to contributions. All this robs pension arrangements of their *raison d'être* but does not exhaust their problems. The Anglo-Saxon pension fund regime is also implicated in such spreading economic distempers as the weakening of major corporations, the aggrandizement of CEOs, great inequality, heavy personal indebtedness and opaque financialization.

One lesson of the great insecurity of private pensions – and in the US employer health benefits – is the need for universal public coverage. Arrangements that depend on the financial health of particular corporations or providers will always be risky. The US economist and columnist Paul Krugman was moved by the desperate plight of DB schemes to write:

American workers at big companies used to think they had made a deal. They would be loyal to their employers, and the companies in turn would be loyal to them, guaranteeing job security, health care and a dignified retirement. Such deals were, in a real sense, the basis of America's postwar social order ... What went wrong? An important part of the answer is that America's semiprivatized welfare state worked in the first place only because we had a stability that – along with any semblance of economic security for many workers – is now gone ... Instead of trying to provide economic security through the back door, via tax breaks designed to

encourage corporations to provide health care and pensions, we should provide it through the front door, starting with national health insurance.

(Krugman 2005)

While no European government is now likely to emulate the DB model they still seem to believe that tax-favoured DC schemes like the IRA and 401(k) are worthy of imitation. I have tried to show how wrong-headed that would be. Significantly the UK Pension Commission has urged that these and other standbys of Anglo-American pension provision are 'not fit for purpose'. To cater for the eight million employees who have no DC scheme membership – and many millions of others who are badly served by such commercial products – the Commission advocates both an 'enhanced state pension', indexed to earnings, and the setting up of a new public agency, the National Pension Savings Scheme (NPSS), to become the receptacle of employee savings (Pension Commission 2005).<sup>10</sup>

Indeed at a time when the core European states are still bent on privatizing pension provision opinion in the 'Anglo-Saxon' states is turning in another direction. The US public, fearing for the future, has so far rebuffed President George W. Bush's attempts to partially privatize Social Security, while the British government's Pension Commission recommends a boost for the state pension and a new public agency to organize pension savings.

## Notes

- 1 I have advanced some specific proposals in Blackburn (2005).
- 2 For a fair way to calculate the sharing of the burdens of the ageing society see the discussion in Myles (2002).
- 3 According to different assumptions the shortfall is estimated at between 4 to 6 per cent of GDP (Pension Commission 2004: 17, 86).
- 4 Quoted by Bartlett and Steele (2005: 38).
- 5 Employers have also sought to replace DB coverage with so-called 'cash-balance' plans which greatly weaken the earnings-linked indexing of DB schemes. Because this severely cuts the entitlement of older workers the courts ruled that they need scrutiny and sanction from the Treasury Department, but the latter has sought to side-step responsibility. See Shultz and Francis (2003).
- 6 The study, conducted by Mihir A. Desai, Daniel B. Bergstresser and Joshua D. Ruh was, according to this report, scheduled to appear in *The Quarterly Journal of Economics*.
- 7 I have more on this in Blackburn (2003). See also Stiglitz (2003: 115–127).
- 8 There is much evidence concerning the first danger (employers using the threat of closure to obtain contribution holidays). The second supposed flaw ('moral hazard' generosity) has been rare because companies have to declare bankruptcy in order to shed pension liabilities, something managers are often loath to do. However Lowenstein cites as an example of such undue generosity the United Airlines decision to increase the value of its pension by 40 per cent prior to entering Chapter 11 in 2002 (Lowenstein 2004). This decision was made after it was already clear that the company was about to enter Chapter 11. Its effect was not to raise pensions by the stated amount because the PBGC does not pay full promised pensions; overall it was designed to safeguard the level of existing pension promises following their assumption by the agency. By this time employees held a large chunk of United Airlines



stock and had representation on the board. This, together with a union promise to cooperate, explains why the usual restraint on management did not operate.

- 9 The UK pension regulator, David Norgrove, explained his decision in a letter which was published in the *Financial Times* correspondence columns on 14 June 2005.
- 10 The candour of the report is welcome but its recommendations are too mild; I propose more radical solutions in Blackburn (2007).

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# 9 The gender pension gap

## Effects of norms and reform policies

*Patricia Frericks and Robert Maier*

### Introduction

The shifts in welfare resource flows and the (re)definition of specific entitlements that took place over the past two decades remodelled the complexity of welfare arrangements. In most analyses, these developments have been considered to be gender neutral. This article shows that, in the case of pension system reform, men and women have been affected differently. The resources to finance the welfare state flow mainly through wages. This is notably the case for the specific welfare arrangement of pensions. Therefore, attributions of entitlements presuppose substantial participation in the labour market, whereas there are two factors that hamper compliance with these presuppositions:

- 1 labour markets are characterized by exclusions and inequalities;
- 2 these disadvantages are reproduced and partly augmented by welfare state arrangements (Harvey & Randles 2003).

Giving shape to welfare state arrangements (and reforming them) means defining, standardizing and implementing norms: it is an ongoing process of formulating the 'normal'. Calculation rules for benefit entitlements, for instance, refer to a specific 'normal' and, to a certain extent, average life course. It implies a standardized biography which, in current welfare arrangements, is centred around labour market participation. In other words, welfare state arrangements institutionalize a standard form of living (Kohli 1986; Krüger 2003; Marshall and Mueller 2002; Mayer and Hillmert 2003; Moen and Sweet 2004). They differentiate between more or less legitimate biographies in the sense of more or less successfully fulfilling the (labour-market oriented) norms. The definition and redefinition of such life course norms or ideal biographies are extremely problematic due to the fact that concrete lives seldom fit the normative ideal. Although the uniform 'objective' life course never actually existed, current life courses manifest even more variations than a few decades ago. The redefinition of calculation rules changes the previously standardized and legitimized norms of a successful life course. However, this redefinition does not correspond to actual population life courses, as empirical studies have shown (ASiB 2001;

Buchmann *et al.* 2003; EC-Report 2003b; Eurostat 2002; Keuzekamp *et al.* 2004; OECD 2002; Sarfati 2003; Veil 2002).

This first far-reaching structural shortcoming is multiplied by a second one: the unit of welfare state norms, which in all countries was the family (although this is something that varies considerably), is in several respects in process of being individualized (increasing individual responsibility). While the individualization of pension entitlements could be positive for women's economic independence, the implementation of these norms is decidedly problematic due to the fact that the eligibility conditions to gain these entitlements have barely been adjusted. Thus, the male breadwinner norm (only marginally adjusted in some cases) now has to be complied also by females. It is true that the participation rate of women in the labour market is on the increase and that this is important for building up pensions. However, it is wrong to think that increasing the labour market participation of women is a sufficient solution to counteract women's lower pensions (as Esping-Anderson (2002) does), because:

- 1 structural shortcomings and gender distinctions, although modified, remain (EC-Report 2003a; Nelissen 2001;
- 2 while caring functions are typically performed by women, the marketization of care is not fully achievable, as recently shown again by Lewis and Guillari (2005).

Life courses and the life course norms instituted in welfare state structures are highly interdependent (Krüger 2003; Moen 2003; Sainsbury 1999). As long as both life courses and welfare state structures remain gendered, the aim of pension reforms to individualize pension entitlements will remain a gendered process (Farkas and O'Rand 1998; Ginn 2004; Leitner 2001). Tendencies to 'modernize' (and de-gender) life course norms and welfare state arrangements can be observed. However, the practical outcomes are limited or ambivalent. This chapter focuses on the male pension-related norms and the persistent inherent gender contract. It argues that the opportunity to build up pension entitlements is influenced by structural gender differences of welfare systems: social and cultural givens restrict the opportunities to comply with pension norms.

We call pension norms the calculation concept to build up full pension entitlements (in the sense of pension formulas such as the German 'Eckrentner' or the Dutch 70 per cent of average income). These calculation concepts are differently constructed per country and may include, aside from wage-related entitlements, residence based basic pensions or care credits, and they are much affected by recent reforms.

The argument is separated into four different pension determining factors:

- 1 labour market participation in the sense of life-long careers, gendered employment, and the influence of taxes and wage arrangements;
- 2 care, including care credits, parental leave, and life course schemes;
- 3 learning, in particular life-long learning;

- 4 the linkage of the sub-systems and their complex influence on pension levels, in other words, the links between pension schemes and so-called 'gender neutral' calculation norms.

### **Structural gender differentiation of welfare systems**

In all European countries the pension norm (that is, the calculation concept to build up full pension entitlements), is related to continuous participation in the labour market. It is an explicit objective of the European Union (Lisbon Agenda) to increase labour market participation for all, also for women. And there is no doubt that increasing women's labour market participation is important in order to increase their pension entitlements and to combat the gender pension gap that exists, to varying degrees, in all European countries (EC-Report 2003a; National Strategy Papers 2002). This is important because in the future, women's dependence on their own entitlements will increase due to the retrenchment in most pay-as-you-go (PAYG) pension benefits (that is, benefits that are financed by contributions from current workers) on the one hand, and the individualization of the responsibility to build up social rights, on the other. However, concepts of full labour market participation with ideal lifelong full-time employment for all are unrealistic for two reasons:

- 1 far reaching changes in the labour markets, including (in some cases) rising unemployment rates (OECD 2002);
- 2 care responsibilities (Lewis and Guillari 2005).

Women's opportunities to build up sufficient pension entitlements have undergone important developments, both positive and negative. None of the developments is unequivocal. However, what is positive for women's social rights is their increasing labour market participation (even in strong male breadwinner states such as Germany and the Netherlands), the introduction of more flexible labour market conditions to facilitate part-time work, and combinations of paid work and care tasks, in the form of, for example, life course regulations (as recently introduced in the Netherlands), better childcare facilities, and/or pension credits for caring responsibilities. The reasons for these developments are practical (to raise the number of contributors and stimulate birth rates to sustain the generational contract), as well as normative (equality, equity).

On the other hand, the overall structure of welfare systems actually consolidates gender differences. Specific mechanisms such as tax systems, labour market arrangements, social rights norms, care facilities and family benefits all influence life courses, and consequently, pension levels. We present a number of examples applicable, in varying degrees, to different systems, in order to show the gendered assumptions of these structures. These examples are grouped according to the four already mentioned pension determining factors:

- 1 labour market participation;
- 2 care;
- 3 learning;
- 4 the linkage of pension schemes.

### ***Labour market participation and pensions***

The first analytical focus is placed on the link between labour market participation and pension entitlements. Pension-related assumptions include 'lifelong' careers as well as full and ideal labour market participation. These assumptions, and the corresponding calculation norms, are mainly seen as being 'gender neutral'. We want to show the extent to which these assumptions, and their combination in particular, are not gender neutral.

#### *'Lifelong' labour market participation*

Contributory periods required to build up full labour market-related pension claims (i.e. occupational pension claims in the wider sense, including public earnings-related pensions), have been extended to so-called lifelong careers. This can be observed in France (where contributory requirements were raised up to 42.5 years), Belgium and Austria (up to 45 years in both cases). Similar calculation norms already existed in many other European systems (Portugal 40 years, Germany 45 years, Italy 40 years) (see Missoc 2004). However, the actual labour market exit age may often be much lower than the official norm. The level of pensions is largely determined by the duration of contributory periods specified in the calculation norm, which has negative consequences also for men, but for women in particular, because interruptions in the work biography (as is often the case for mothers) substantially influence pension claims. If, for instance, we look at France, Veil's analysis shows that basic pensions shrink by about 50 per cent if five of the current 40 insurance years are missed (Veil 2002). Many men also fail to meet the 40 year criterion; however, apart from more general reasons, women often have an additional reason for interrupting their participation in the labour market: child rearing.

Another form of increasing the importance of extended labour market participation is the introduction of bonus-malus regulations (Sweden, Portugal, Austria, Italy, Germany, malus in Spain, bonus in the UK) (see Missoc 2004). These innovations in calculation norms stimulate people to continue working by introducing 'carrots and sticks', which benefit people who stay in the labour market longer than the official calculation norm, and punish those who leave earlier. In the coming decades, these regulations will affect women's pension claims more profoundly for two reasons: first, recent pension reforms in several countries have changed women's retirement age to make it the same as for men (Germany, Belgium, Greece, Austria, UK) (Missoc 2004); second, women's participation rates in old age tend to fall more rapidly than men's (see Table 9.1). Data on the total employment rate (for ages 15 to 64) show a significant

Table 9.1 Employment rates in 2004

		<i>Employment rate</i>		<i>Gender employment gaps*</i>	
		<i>15–64</i>	<i>55–64</i>	<i>15–64</i>	<i>55–64</i>
EU 15	Men	72.7	52.2	0.78	0.64
	Women	56.8	33.2		
Austria	Men	74.9	38.9	0.81	0.50
	Women	60.7	19.3		
Belgium	Men	67.9	39.1	0.77	0.54
	Women	52.6	21.1		
Denmark	Men	79.7	67.3	0.90	0.79
	Women	71.6	53.3		
Finland	Men	69.7	51.4	0.94	0.98
	Women	65.6	50.4		
France	Men	69.0	41.0	0.83	0.82
	Women	57.4	33.8		
Germany	Men	70.8	50.7	0.84	0.65
	Women	59.2	33.0		
Greece	Men	73.7	56.4	0.61	0.43
	Women	45.2	24.0		
Ireland	Men	75.9	65.0	0.74	0.52
	Women	56.5	33.7		
Italy	Men	70.1	42.2	0.64	0.46
	Women	45.2	19.6		
Luxembourg	Men	72.4	38.5	0.70	0.59
	Women	50.6	22.9		
The Netherlands	Men	80.2	56.9	0.82	0.59
	Women	65.8	33.4		
Portugal	Men	74.2	59.1	0.83	0.72
	Women	61.7	42.5		
Sweden	Men	73.6	71.2	0.96	0.94
	Women	70.5	67.0		
Spain	Men	73.8	58.9	0.65	0.42
	Women	48.3	24.6		
UK	Men	77.8	65.7	0.84	0.72
	Women	65.6	47.0		

Source: Eurostat 2005 (epp.eurostat.cec.eu.int).

Note

\* Women's employment rate over men's employment rate.

gender gap in most countries (only marginal in Sweden and Finland). However, the employment gap of older people (aged 55 to 64) is even much wider (with the exception of Finland).

Gendered participation rates of older people occur even in countries with high female labour market participation, such as the Netherlands and Denmark. For many women, this will probably be the second non-working period in addition to parental leave.



*Gendered employment*

In addition to the gendered labour market participation with respect to the number of years of employment, there are additional gender distinctions in labour market participation also within working years, such as part-time employment and labour market segregation. Gendered labour market participation can, in varying ways, be observed in all European countries. When, for instance, we look at the so-called ‘Dutch miracle’ of the 1990s, with its significant increase in the number of women participating in the labour market, and which is frequently quoted as an example of successful policy, the fact that most Dutch women work part-time is not taken into account to a sufficient degree. This kind of gendered labour market participation is no exception: in the OECD region three-quarters of part-time jobs are held by women (OECD 2002; Jau-motte 2003; see also Table 9.2).

In 1997, the European Union even adopted a directive on part-time work to guarantee part-time workers the same conditions as full-time workers (Bleijen-bergh 2004). However, working part-time, and working for lower wages in general (see Table 9.3), for instance, as a result of labour market segregation, to say nothing of precarious employment positions, means that income is lower. With lower incomes, employees are barely able to build up pension claims in the wage related (occupational and private) schemes, which are of particular importance also in countries with a citizenship-based basic pension (see, for instance, Nelissen 2001). Several restrictions on access to occupational schemes, which negatively influenced women’s opportunities to build up sufficient pension claims, have diminished within the last two decades thanks, among other things,

*Table 9.2* Persons employed part-time in 2004 (percentage of total employment)

	<i>Men</i>	<i>Women</i>
EU 15	7.2	35.2
Austria	4.9	38.6
Belgium	6.8	41.0
Denmark	12.5	33.9
Finland	8.7	17.8
France	5.2	30.0
Germany	6.5	41.6
Greece	2.2	8.6
Ireland	6.1	31.9
Italy	4.9	24.8
Luxembourg	2.4	40.2
The Netherlands	22.5	74.8
Portugal	7.0	16.1
Sweden	12.4	36.4
Spain	2.8	18.3
UK	10.6	44.2
Norway	15.0	45.8

Source: Eurostat 2005 (epp.eurostat.cec.eu.int).

*Table 9.3* Gross hourly earnings of women in public and private sector (in percentage of men's earnings in each sector)

	<i>Public sector</i>	<i>Private sector</i>
EU 15	87	82
Austria	92	76
Belgium	92	88
Denmark	97	92
Finland	83	85
France	89	84
Germany	77	73
Greece	91	79
Ireland	90	82
Italy	101	89
Luxembourg	:	:
The Netherlands	79	81
Portugal	108	79
Sweden	:	:
Spain	93	83
UK	83	85

Source: Eurostat (2002).

Note

: Data not available.

to influences of the European Union. However, what is more important and continues to be problematic are the gendered positions on the labour market in combination with the 'gender neutral' calculation norms.

### *The influence of taxes and wage arrangements*

The building up of occupational pensions is influenced by tax regulations and wage arrangements. Tax systems in several countries are organized assuming a 1.5 earner household (Dingeldey 2001; Lewis and Guillari 2005; Sainsbury 1999 and 2001), where the 0.5 earner is usually the woman. Tax regulations as an implementation of family support policy, or employer-friendly policy, work in favour of traditional gender roles and thereby in favour of a secondary position of women's wages and social entitlements. In contrast to the purely marriage-oriented German income tax system which favours a 1.5 earner household, the French system calculates tax duties on the basis of a family-quotient: each child reduces the part of the income on which tax has to be paid. In fact, half of French families do not pay income tax (KAS 2004). In addition, there are tax incentives that have a positive effect for French mothers, such as tax relief for company-provided childcare facilities. However, even within the French system, tax regulations were introduced that work out ambiguously for women's pensions. In 2003, two tax incentives were introduced that will reinforce gender distinctions:

- 1 for parents to take care of their children by themselves;
- 2 for mothers to temporarily interrupt employment (Veil 2004: 19).

The introduction of these incentives strengthens, also in France, the traditional roles of the caring mother on the one hand and the (paid) working father on the other, and acts as an incentive to a 1.5 earner model.<sup>1</sup>

To summarize the gendered link between the labour market and pension entitlements: for several reasons women's opportunities to build up pension rights through participation in the labour market are different from those of men. The complex reasons for women's secondary position on the labour market are described in more detail by, among others, Sarfati (2003). This secondary position on the labour market results in a life course wage gap from which the pension gap is derived (Table 9.4).

In order to differentiate between 'derived'<sup>2</sup> and 'non-derived' pension benefits (which is crucial in the light of the development toward the individualization of pensions), much more information is needed (for instance, how much of the post-65 income derives from individually gained pension entitlements). Available data for Germany clearly shows that the gender gap in personally-obtained benefits is much larger than the post-65 average income gap: while the data given in Table 9.4 show that the relation of women/men post-65 income is about 0.88 in average, and 0.81 for persons living alone, the German old age security

*Table 9.4* Average equalized income of men and women aged 65 and over, 1997 (percentage of average income of people under 65)

	<i>Aged 65 and over</i>			<i>Aged 65 and over living alone</i>		
	<i>Men</i>	<i>Women</i>	<i>W/M</i>	<i>Men</i>	<i>Women</i>	<i>W/M</i>
EU 15	88	80	0.91	84	69	0.82
Austria	91	80	0.88	99	71	0.72
Belgium	111	97	0.87	101	82	0.81
Denmark	77	70	0.91	67	63	0.94
Finland	95	79	0.83	85	66	0.78
France	98	89	0.91	92	80	0.87
Germany	102	90	0.88	97	79	0.81
Greece	75	69	0.92	76	56	0.74
Ireland	77	71	0.92	58	52	0.90
Italy	97	90	0.93	100	79	0.79
Luxembourg	:	:		:	:	
Netherlands	98	89	0.91	109	81	0.74
Portugal	82	75	0.91	74	59	0.80
Sweden	99	87	0.88	76	72	0.95
Spain	98	94	0.96	102	73	0.72
UK	73	63	0.86	64	52	0.81

Source: Eurostat (2002).

Note

: Data not available; Finland: 1996.

report (ASIB 2001: 112) specifies that the relation of *own* old age entitlements for women/men lays at 0.33 (0.29 for the former West Germany and 0.55 for the former East Germany).

In short, the wage-related pension gap is widened by the 'gender neutrality' of pension calculation norms as the French example of the 'terror' of the 40 years required by the pension norm shows (Veil 2002). Gender pension gaps, as the European Commission points out, do not necessarily decrease as a by-product of increasing female participation rates, as they are linked to structural gender inequalities in the labour market (EC-Report 2003a).

### ***Care and pensions***

The second focus of this chapter is on care and its influence on pension levels. There are many different forms of care including childbearing, care for children, care for the elderly and care for others. However, it is beyond the scope of the present article to adequately analyse all these different forms. In addition, care-related pension policy is at the beginning of its development, and focuses in particular on childcare. Therefore, our emphasis is placed on this form of care, which is partly recognized and practically widespread.

### ***Care credits***

Mainly countries that lack citizenship-based pension provisions, as for instance France, Germany and Austria, have introduced and developed measures to improve women's 'non-derived' pension entitlements. Pension entitlements of women in France and Germany, for example, are, on average, half of men's entitlements (Veil 2002). This is surprising, because in these countries, both female labour market participation as well as childcare facilities are very different. To reduce these gaps, care credits were introduced, in Germany and Austria much later than in France, and have been subject to ongoing substantial revisions. Yet, even in their latest form, they are not sufficient to counteract gender pension gaps. They are inadequate particularly when there is stronger dependence on several schemes (rather than just the public one), because these credits tend to be restricted to public pensions. We will analyse the influence of care credits in more detail for two different systems – France and Germany.

France provides childcare pension credits for two years per child. Recent reforms changed the conditions for these pension credits, and thereby counteracted the previously positive example of French childcare pension provision. For children born after 2004, work cannot be continued as was previously the case, but has to be interrupted if parents want to be entitled to child credits. The reasons for reforming childcare credits were legal disadvantages for men since the mother-focused welfare arrangements were seen as discriminating against men. In effect, however, the required minimum interruption of work of two months is, simply for biological reasons, more likely to be taken by the mother. While the old regulations gave credits to one of the parents, generally the

mother, independently of their decision concerning labour market participation, the new measures tend to push mothers out of the labour market.<sup>3</sup> The former regulations, although not perfect, were better both from a normative point of view (additional pension value, related to children, on top of wage-related contributions), as well as from a practical one (women could receive childcare credits and continue to work without interrupting their profession, which was facilitated by state-provided childcare facilities). In most professions, as is generally known, interruptions are disadvantageous for career paths, skill levels and wage levels (Schmid 2004).

There is, however, a questionable implication in both regulations: if parents decide to care for their child themselves, or are forced to do so because of a local lack of childcare facilities, it is traditionally the mother who interrupts her career and, as such, this means that the traditional gender roles are maintained. In addition, childcare credits (*annuitiés pour enfant*) are only given within the basic pension system, and care time is not taken into account for additional occupational or private pensions.

Furthermore, additional benefits credited to large families (*majoration pour enfants*) are familialized and gendered through wage percentage calculations: apart from the fact that mothers of three or more children (that is, large families), hardly participate at all in the labour market, calculations based on wage percentages are particularly beneficial for (male) higher wage workers. So, if we take the French system as a whole, it continues to be male-breadwinner oriented and familialized. It is certainly not de-gendered and individualized.

Care credits in Germany are again different. As a result of the 2001 pension reform, one parent (which is mostly the mother), builds up pension claims for three years per child born after 1992 and one year per child born prior to that date (*Kindererziehungszeiten*). The state pays lump-sum contributions for one parent. This means that becoming a parent implies some entitlement to a pension that is guaranteed by the state. However, Germany's welfare system is still highly familialized. Its holding motherhood in high esteem is ambiguous as can be seen when it comes to additional upgrading pension credits and part-time work (*Kinderberücksichtigungszeiten*). In Germany, the coverage of care facilities for children as of the age of three is more than 100 per cent. Most of them (70 per cent) are part-time facilities. Facilities for children younger than three cover just about 7 per cent (with huge differences between the former East and the former West Germany) (see Table 9.5).<sup>4</sup>

Therefore, the two forms of German care credits are quite functional. First, the three years lack of care facilities are compensated by three years of (full) pension entitlements. Second, the part-time facilities for children of three years and older, including school, are compensated by an additional seven years of partial pension entitlements to upgrade pension contributions of lower income or part-time work. And although these care credits have a positive influence on mothers' pension entitlements for those years, the related (full or partial) interruption of labour market participation involves negative consequences for other years, mainly the difficulty of re-entering the labour market both because of a

Table 9.5 Care facilities in Germany (by 31 December 1998) (places available as a percentage of children of the relevant age)

	<i>West</i>	<i>East</i>	<i>Total</i>
<i>0–3 years</i>			
Crèches	2.8	36.3	7.0
Full-time			6.3
Part-time			0.7
<i>3–6 years</i>			
Day nursery	102.0	132.0	105.0
Full-time			29.4
Part-time			70.6

Source: Statistisches Bundesamt (2001).

lack of practice and skill improvement as well as reservations on the part of employers.

### *Parental leave*

More women than men do take parental leave. In Germany, for example, the share of fathers in the 1990 cohort claiming parental leave never exceeded 2 per cent (Born 2003). With fathers having the official right to take up parental leave, it seems to be a matter of ‘negotiation within an “egalitarian” couple’ (Born 2003: 293) that leads to the decision about who takes the leave. However, due to ‘unequal tandem arrangements’ (Krüger 2003: 48) the result is a ‘neo-traditional behaviour of women’ (Born 2003: 290).

Varying per country, this neo-traditional behaviour has different effects on women’s pension and employment situations. While some countries introduced an employment reintegration guarantee following a period of parental leave, others hardly offer such rights (Drew 2005). Nevertheless, even in countries where such reintegration guarantees exist, women in fact do face difficulties when it comes to re-entering. We showed for Germany, for instance, that child-care facilities for children from the age of three, that is, after the possible period of parental leave, are in most cases part-time: most kindergartens and schools are part-time facilities. If mothers start working again after three years’ parental leave, the employer is generally obliged to offer a ‘comparable’ position. However positive this sounds, strict interpretations of this legislation may only lead to offering a full-time job for a former full-time worker who may no longer have the opportunity or the wish to work full-time.

Finally, financial support for the caring parent during parental leave varies significantly. While Scandinavian countries offer relatively generous wage replacements, financial support in other countries tends to be very limited. In Germany, for example, mothers receive quite generous pay during pregnancy leave; however, support for parental leave is marginal. To pay flat-rate benefits for periods of parental leave influences the decision of parents: if fathers, who

generally have the better jobs, take up the leave, the loss of family income is much greater. 'Daddy leave' is therefore rare. This is also the case in countries with more generous benefits as a percentage of the wage because the family wage loss, in general, is greater if fathers take the period of leave. Yet, to motivate families to, nonetheless, break traditional gender roles, specific claims could be linked to certain de-gendering behaviour such as taking up a period of 'daddy leave' (as is the case in Sweden and planned in Germany).

### *Life course schemes*

The relationship between care and pensions depends on the dominant life course norm and its concretization in life course regulations. In the past, the largely male-breadwinner oriented welfare and labour market systems were consistent with the biography of the majority of employees, who were men. Changes in labour markets, economies, life-expectancy and welfare states as well as in individual lives and households led to changes in the concept of the life course. Currently, this concept is no longer the gender-differentiated three-phase life course scholars speak about (learning, working and retiring for men; learning, mainly caring and reduced caring for women) but a less gendered four- or five-phase life course with much less chronology of the different activities such as learning, working, caring (Laslett 1996; MinSZW 2002).

This reformed life course concept has started to influence welfare arrangements. In the Netherlands, for instance, a 'Life Course Saving Scheme' (*Levensloopregeling*) was introduced (Keuzekamp *et al.* 2004): as of 2006, employees have the opportunity to save wages for non-working periods in order to care for children or the elderly, but also for education, leisure or early retirement. Parental leave will, in the future, only be offered within this legislation. And although within this regulation parental leave is subsidized, there are serious shortcomings since the period of labour market participation before parenthood is in general quite short. Thus, it is not very likely that the time that may be saved before parenthood is substantial. It is anyway very limited in relation to childcare facilities. In addition, prospective studies show that men will rather save for their early retirement, whereas women will mainly save for the 'peak hour' of life, that is, periods of childcare (CPB 2004). This development can already be observed in the existing life course scheme (*time credit system*) in Belgium where 'the time credit system seems to be evolving from an instrument to reconcile work and family life to a road to early retirement' (Debacker *et al.* 2004: 22).

Explicit life course schemes are just starting to find their way into welfare arrangements, and policy on life course schemes within the European Union (EC 2005) is still very limited (emphasizing part-time directives and simply stating fathers' lack of interest in parental leave). Yet, the phenomenon is far from new: each European country has, in a way, a life course regulation: pension entitlements reflect the extent to which one's life fits in with the specific life course norms. As Marshall and Mueller (2002: 31) put it: 'Much existing social policy relies on an assumed "standardized" or normative life course.' But while the unit



of these norms changes from households to individuals (Mayer and Hillmert 2003) the institutional and cultural changes are far from going along with these far-reaching shifts. This discrepancy has the most negative effects, of course, for those on whom the original norm was not focused: women.

To conclude, if care credits are evaluated as positive for women, one should be critical about the conditionality (whether they are, for instance, only given if women exit the labour market), the practical circumstances (do parents have a choice? Are care facilities available?) and the factual outcomes of such credits in the system as a whole. If the manner of calculating pensions in countries that do not provide pension care credits results in similar pension levels as those received by mothers in countries that give care credits (both with the same interruption of labour market biography), the concept may sound positive for mothers but the outcomes are not.

In addition, a couple's decision to maintain the traditional gender roles of the female carer and the male breadwinner has to be seen within two circumstances:

- 1 the life course's 'embeddedness in "linking institutions"', in other words, individual life courses are shaped by welfare state designs and embedded in the 'multiple logic of institutionalized normalcy assumptions' (Krüger 2003: 35, 50);
- 2 the decision-making within 'linked lives', i.e. 'how women's "choices" are often constrained by their husbands' circumstances' (Moen 2003: 245).

In short, it is the combination of 'structural lag', 'social givens' and 'linked lives' that results in a limited range of individual choices and 'often serves to reconstruct and exacerbate gender inequality' (Moen 2003: 251).

### ***Learning and pensions***

Pensions are strongly influenced by the level of education due to the fact that wages are generally higher for better skilled employees. Since education and skill enhancement are no longer restricted to one phase of life, the position on the labour market, and with this the level of pension entitlements, depends on both basic and continuing education.

The concept of the 'life course regime' (Kohli 1986) of strict and chronological division of life phases in learning, working and retirement as a 'blueprint for most middle class white men' (Moen 2003: 237) is obsolete. First, gender differences in education levels are diminishing in most European countries, although there are still rather typical gender distinctions in the subject of education (Eurostat 2002; OECD 2004). Second, the last two decades have seen a considerable shift towards a continuation of education, learning, retraining, further training etc., established first of all in Scandinavian countries, and referred to as 'lifelong learning'. Skill improvement and updating knowledge is essential not only for becoming employed but also for remaining employed (Lassnigg 2005). Two important factors should be mentioned on how lifelong learning underpins

gender distinctions. First, career breaks due to childcare make it difficult in certain professions to remain 'fit' for the job, in the sense of updating and practicing skills. Employers often experience parental leave as akin to deskilling (Buchmann *et al.* 2003). This linkage of the disadvantages caused by times of leave and the assumptions about this time of leave results in difficulties to return to education and learning, and it is a 'clear evidence of cumulative advantages and disadvantages in learning over the life course' (Marshall and Mueller 2002). Second, the likelihood of young women becoming mothers and therefore being absent from work, may provide reasons for employers to prefer investing in young men rather than young women. This form of the so-called 'statistical discrimination' has, of course, a deep impact on future careers, and therefore on pension levels (Buchmann *et al.* 2003; Esping-Andersen 2002).

In short, lifelong learning, which is essential in terms of wage levels and labour market participation in general, is gendered not only due to care responsibilities but also as a result of statistical discrimination.

### ***Links of pension schemes and their complex influence on pension levels***

In addition to life course internal factors, pensions are also strongly influenced by the links of the different subsystems in the overall pension system. In this section we examine the interrelation of the different pension schemes and the 'gender neutrality' of calculation norms.

#### ***Linkage of schemes***

In all European countries, public schemes are key in particular for women, because fewer women than men have occupational pensions, and when they do, the amounts they accrue are lower (Anderson 2005; Ginn 2004; Nicoletti and Peracchi 2003; Sainsbury 2001; Veil 2002). In most countries, benefits have been continuously subject to political considerations so that different technical procedures, such as changed indexation rules, determined the level of public pension benefits (Germany, France, the Netherlands, Denmark) (see DRV45 2003). Over the past few decades, these political considerations have mainly resulted in retrenchments that were assumed to be necessary to secure the sustainability of the PAYG systems (Bonoli *et al.* 2000). In order to sustain these contribution-financed schemes, they were partly equilibrated by general revenues, while in order to counter future benefit losses caused by retrenchment within these schemes, wage contributions were partly shifted towards private investments (both, for instance, in France and Germany).

Thus, increasingly, full pension entitlements depend on participation in different schemes. According to the country, this may mean residency-based pensions combined with at least the mandatory occupational pensions (the Netherlands, Denmark), or public occupational pensions in combination with private schemes as recently introduced in the German system. However, the

problem is that the result in terms of pension benefits from a combination of sub-schemes does not necessarily correspond to the theoretical sum of the independent benefits from the sub-schemes. Indeed, the linkages between schemes can have negative effects for low earners, and in many cases for women, such as shows the example of the *Franchise* in the Netherlands. The result in terms of pension benefits can therefore be disproportionate to previous wage levels. A quite different problematic effect can be identified when considering the many existing forms of tax subsidies supporting the private pension schemes, another category of sub-schemes. These already existing or newly introduced private schemes (as in France and Germany) become part of the overall pension blueprint, with the argument to compensate retrenchment in the other sub-schemes. However, many of the existing tax subsidies are (still) solely advantageous for better income earners, who are, as said before, more often men than women.

Subsidies to private schemes show a tendency to abolish some privileged categories and to create new groups of beneficiaries. A striking example is the German *Riester-Rente*: Germany introduced childcare credits in private schemes by using general revenues to improve mothers' opportunities to build up additional private pension entitlements (Veil 2002).<sup>5</sup> This is, therefore, one example of how concepts can be interpreted and implemented in unconventional ways. Partly tax-financed schemes can more legitimately be used for non-contribution related entitlements such as care credits. Yet, this example of 'family-friendly' regulations within private schemes is rather unique as the following examples show.

An additional scheme, introduced in Denmark in 1997, aiming at better redistribution of income in old age, was subject to a striking development. The Special Pension Saving (*Særlig Pensionsopsparring, SP*) was introduced with the intention of benefiting low-paid groups by providing similar benefits for all contributors. It is financed by 1 per cent of earnings of wage earners, the self-employed and some groups of social benefit claimants. The original idea was to take this 1 per cent of the (different) incomes and to convert it into an equal, wage independent pension supplement for each contributor. However, in 2002, the re-distributive elements were rejected by transforming the uniform pension supplement, financed by the quasi-tax of 1 per cent of income, into an individual compulsory pension with earmarked contributions and benefits so that 'the one million richest Danes gain a higher annual pension saving, whereas the poor lose on their pension savings' (criticism in Abrahamson and Wehner 2003: 15).

In the Netherlands, too, a new way of building up pensions was introduced in 1994, and developed in an unforeseen and misjudged way: the so-called *Spaarloon*, a tax-advantaged saving scheme. By using saving schemes to dampen wage demands, workers were able to increase their income free of social contributions, and 'tax avoidance [was] legally' established (Cox 2000: 25). If these savings were invested in private pension schemes within the named regulation to reach the 70 per cent of the last income as pension level, these investments were again reduced from the taxable income. These private pensions, therefore, were

up to fully financed from general revenue. Many efforts were made to cut back this legislation since the first months already showed the unintended outcomes.

Both examples show that countries introduced programmes that provide special advantages to an economically privileged part of the population. Such programmes manifest an ironic kind of solidarity: they not only exclude the less well-paid (mainly women), but in addition they are financed by taxes that are also paid by those who do not benefit from such programmes. This produces a regressive redistribution: the most (financially) successful people in the labour market receive extra rewards.

### *'Gender neutral' calculation norms*

As argued earlier on in this chapter, pension calculation norms are not gender neutral mainly because they apply an ideal labour market related norm. A striking example is the Dutch calculation norm, the *Franchise*. The *Franchise* is a wage level, in principle identical to the basic pension (Algemene Ouderdomswet, *AOW*), which is generally taken as the threshold above which additional occupational pension claims can be built up. However, the *Franchise* does not reflect realistic individual AOW entitlements. First, assumed AOW levels may differ from real ones due to future pension cuts. Second, the *Franchise* is calculated with a partner-AOW of 100 per cent or a single AOW of 70 per cent, while in a partner household each partner only gets 50 per cent. Taking the *Franchise* as the basis of calculation for additional pensions, which most pension funds do, is relatively unprofitable for low income earners: only above this minimum level do employer and worker contributions build up occupational pension entitlements. Calculation norms, including the *Franchise*, imply that double income of an employee may lead to fourfold pensions (Herderscheê 2004).<sup>6</sup>

In general terms, there have been additional developments in calculation norms that determine pension levels in a positive as well as a negative sense: while qualifying or 'waiting' periods (that is, minimum contribution periods to be entitled to pension rights) have been shortened (in Italy from 20 to five years, in the Netherlands from ten to five years), and some countries' policy aims at full coverage of employees to be insured in occupational schemes by reducing discriminatory exclusions (mainly of mothers), the problem of the level of future pensions has been left out of consideration. Women's pensions have been, for instance, negatively affected by raising the number of wage years used as the basis for benefit calculation (in France from the best ten to the best 25 years, in Austria from best 16 to the best 40 years, equivalent to a lifelong career, in the Netherlands from end salary to average salary, and so on). While many disadvantages for women to build up pension entitlements are diminishing thanks to European and national regulations (unisex life tables, conditions to join occupational schemes, and so forth) many important aspects to reduce gender pension gaps are not yet legally binding. It is not the position of the authors that state regulations are per se better or that they are needed in all

details. Nevertheless, many obstacles for women to build up adequate pension entitlements seem to remain as long as interventions are not taken. Building up full pensions is a challenge that requires investment in several pension arrangements. However, some linkages of sub-systems mean that pension levels are disproportionate to the wage levels, and therefore some welfare arrangements increase the wage gaps and result in even wider pension gaps.

## **Conclusions**

We close our analysis with some conclusions directly based on the concrete measures analysed above, and some more general ones. First of all, conclusions concern the gendered structures of the different systems, and the insufficient rectifications to level off gender pension gaps.

To rectify the seemingly individual disadvantages of women does not eliminate the countless structural gender disadvantages: while in some systems the norms of years of insurance may be complied with by women thanks to rising labour market participation in combination with care credits, women will hardly ever reach the level of men's pensions. Due to the fact that pension systems are mainly related to labour market participation, and due to the fact that wages and labour markets are gendered, pensions are per se gendered.

Policies to balance gender pension gaps follow divergent paths. While some systems tend to maintain gender roles by introducing benefits such as care credits, others intend to introduce de-gendering measures such as life course schemes. However, the measures that have been implemented based on these policies are inadequate to eliminate gender pension gaps and in some cases these gaps have even increased. Care credits, for instance, are insufficient when taking into account the incompatibility of care facilities and work participation requirements, and the necessity to build up pensions in different schemes while care credits generally only affect entitlements in (decreasing) public pensions. This inadequacy is particularly striking since pension systems aim to provide opportunities for all citizens to build up the pensions proportionate to wages. Most systems, although to varying degrees, continue to work with traditional family and gender role concepts as far as political measures, labour market structures and calculation norms (including entitlements and taxes) are concerned. Seemingly gender-neutral laws, and even 'women-friendly' measures, do not lead to adequate options for both men and women to build up pensions.

There is a twofold development in reforming welfare arrangements. On the one hand we observe political efforts to implement gender equality and equity. On the other hand measures and argumentations are focused on traditional (ideal and primarily male) labour market participation. Contrasting developments are taking place also caused by the intensified linkage between labour market policy and pension policy based on arguments such as sustainability and dependency ratio (CPB 2005; OECD 2005). It is obvious that the state, acting as an important regulator, is not absent and that new values (realized in forms of credits for, for instance, care) are being introduced in pension systems. Resulting from this

combination of diverging interests, pension systems are developing towards a complex mixture of different schemes.

This ambiguous policy is accompanied by a further ambiguity: the increasingly individualized responsibility for one's old age income. The concept of individualization changed the structure's label but not its essence: the 'individualization' of pension calculations is a paradigmatic example of how welfare arrangements proceed in terms of a male breadwinner tradition. Welfare arrangements are torn between the individual unit and the family unit. This is, at the same time, a standardization of, and a result of, (still) gendered life courses (Fux 2002). With respect to calculation norms, countries should find their own mix, including solidarity, proportionality, a balanced mix of different schemes, and policies to balance various forms of gendered labour market participation. Taking into account the influences of the overall structures of welfare states, concepts should be discussed that aim to de-gender the life courses of both men and women, as for instance, the Dutch project of a 'combination scenario' as a kind of 'flexicurity' concept that strives to combine social security with a more flexible labour market and family situation.

Finally, it is the overall composition of each welfare system that determines pension levels. Varying measures were introduced in the unique welfare systems of each country. While some of them explicitly aim at improving women's and mothers' pensions, others were introduced to influence other policy areas, generally based on a rather 'gender neutral' perspective or, more critically formulated, a gender blind one. The overall outcomes for women can only be understood within the unique combination of different measures and circumstances in each country. These might appear in forms of labour market policies, tax regulations, care credits and facilities, cultural norms (bad mother, bad employee), calculation norms, specific mixes and shifts of pension schemes and so forth. As long as the analysed factors are not taken into account, reforming welfare states will have, in one way or another, gendered pension effects.

## Notes

- 1 In many countries, several measures to improve women's pensions or women's opportunities to work also as mothers depend on tariff agreements such as care credits within (additional) occupational schemes and company arranged childcare facilities.
- 2 Pensions are always 'derived' from something, from labour market participation or from having children as we will see below. However, the official use of this term is linked to derived rights as a spouse, in general, rights derived from the husband.
- 3 Reasons to interrupt or stop working may be manifold; however, welfare state arrangements, and among them pension regulations, play a role in decision-making, as we will show in more detail below.
- 4 The latest statistics on care facilities in Germany, at 31 December 2002, are less clearly differentiated but comparable: in total; there are 85 places for crèches for every 1,000 children up to the age of three. For every 100 children aged three to six there are 38.2 full-time places, including lunch facilities (Statistisches Bundesamt 2004).
- 5 In fact, *Riester* entitlements are necessary to maintain the current level of public pensions. The term 'improvement', therefore, is improper.
- 6 In the UK, the Dutch pension system with its basic pension is currently seen in a very

positive light, and even worth copying. However, it is the UK itself that is experiencing the challenging development of part-time employment as for instance citizens' accumulation of jobs to circumvent poverty.

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# 10 Generational equity

## Concepts and attitudes<sup>1</sup>

*Martin Kohli*

### Introduction

The concept of generational equity highlights the importance of pension policy for the social fabric. Generational equity has become one of the major issues of contemporary societies. In the history of most Western welfare states, the key 'social question' to be solved was the integration of the industrial workers, in other words, the pacification of class conflict. This was achieved by giving workers some assurance of a stable life course, including retirement as a normal life phase funded to a large extent through public pay-as-you-go contribution systems or general taxes (Kohli 1987). In the twenty-first century, class conflict seems to be defunct and its place taken over by generational conflict (Bengtson 1993; Kaufmann 2005). The new prominence of the latter is due both to the evolved patterns of social security which have turned the elderly into the main clients of the welfare state, and to the demographic challenge of low fertility and increasing longevity.

Such an assertion needs to be qualified in two ways. First, it should be noted that conflict or competition between young and old over scarce resources is by no means new. It has been a common theme in historical and anthropological accounts of pre-modern societies as well (see Foner 1984; Williamson and Watts-Roy 1999). But with the evolution of the modern welfare state the form and arena of this conflict have changed. Second, and more importantly for our present concerns, it remains essential to assess the extent of the generational cleavage per se and the extent to which it masks the continued existence of the class cleavage between wealthy and poor (or owners and workers). In other words, to what extent have the new *inter*-generational conflicts really crowded out traditional *intra*-generational ones? There are moreover other cleavages that are usually categorized as 'new' dimensions of inequality (in distinction to the 'old' ones of class), such as those of gender and ethnicity (or 'race').

Issues of equity or justice play a prominent role in adjudicating conflicts and legitimizing their solutions along all these cleavages. Modern democratic polities, evolving under conditions of individualized participation in public affairs, increasingly depend on broad cognitively-based acceptance by their citizenry, and thus rely on commonly shared (universal or local) sources of legitimacy such as those provided by justice ideas.

It is with these ideas and their empirical manifestations that the present chapter is concerned. It poses three questions: how have ideas about generational equity been organized in public discourse, how do they manifest themselves in the attitudes of the population towards the welfare state and pension reform, and how are the contradictions between public discourse and popular attitudes to be explained? The next section discusses the basic concepts: age and generation, and relates them to the issues of justice. In the third section, the discourse on and institutional anchoring of generational equity are reviewed. The fourth section describes the patterns of public attitudes and beliefs concerning justice among generations, the role of the state and other possible providers of social security, and the acceptability of various reform proposals. The final section takes up the explanatory task by returning to the issue of inter- vs. intra-generational conflict and discussing the link between the public and the private generational 'contract'.

### **Age and generation**

Age is relevant to justice concerns in terms of the aggregation of individuals into age groups and generations or cohorts as socially delimited entities. And as will be seen, age groups per se are not really problematic; it is the differentiation into generations that creates the major problems in terms of distributive justice or generational equity.

It needs to be emphasized that age groups are not given but socially constructed through the institutionalization of the life course. 'The elderly' as a category are today directly predicated upon the institutionalized age boundary of retirement and access to pensions. Changing this boundary would create different relative sizes of age groups, and thus change the distributional balance. Raising it has therefore become one of the main avenues in the current reform (or retrenchment) of pension systems. Such changes, however, are difficult to implement because these age boundaries, although socially constructed, are not freely available to political intervention – they are linked to basic structural properties of welfare states and labour markets (e.g. seniority wage systems) and stabilized through deeply entrenched biographical orientations and expectations (see Kohli 1994).

In all modern societies, the elderly are the main recipients of public income transfer programmes, while children – even when taking child allowances and the costs of schooling into account – are to a large part financed privately by their parents. Such unequal allocation of public resources among age groups may be considered 'unfair' or ineffective if, for example, its outcome is that one group is consistently worse off than another. But in principle an unequal treatment of age groups is perfectly legitimate. The reason is that age for individuals is not a fixed characteristic (see below). Age groups are entities with regularly changing membership, with all individuals progressing through the life course from one age group to the next according to an institutionalized schedule.

With generations this is not the case. The concept of generation can be

defined with regard to society or to family – two levels which are usually analysed separately but need to be treated in a unified framework (Kohli and Szydlik 2000). At the level of the family, generation refers to position in the lineage. At the societal level, it refers to the aggregate of persons born in a limited period (i.e. a birth cohort according to demographic parlance) who therefore experience historical events at similar ages and move up through the life course in unison. One may take one's distance from one's societal generation but one cannot leave it in this formal sense – it is a fixed-membership entity.

Under what conditions and to what extent this common socio-historical location experienced by a birth cohort throughout its life leads to a shared consciousness of being a generation and to a common mobilization as a societal actor has been the subject of intense argument and (still contentious) research. What is clear, however, is that the concept of generation is a key to the analysis of social dynamics. In the sequence of generations, families and societies create continuity and change with regard to parents and children, economic resources, political power and cultural hegemony. In all of these spheres generations are a basic unit of social reproduction and social change – in other words, of stability over time as well as renewal (or sometimes revolution).

As these brief remarks show, the idea of conflict or competition between young and old is by no means new. But it may have taken on a new form of institutionalization in the modern era, with the evolution of the welfare state and the emphasis on societal dynamics and progress through the replacement of old by new generations. A case in point for the latter is the youth movements at the beginning of the twentieth century. They celebrated and mobilized youth as the vanguard of cultural and political change, and even as a higher form of human existence, necessarily at war against the adult world (Wohl 1979). The contemporary history of the conflict dates from the institutionalization of age-based social security (Williamson and Watts-Roy 1999). This brought the distribution of resources between young and old – later to be addressed as the problem of generational equity – into public focus.

### **Generational equity: discourse and institutions**

As mentioned above, public beliefs about whether social arrangements are just play an increasing role today. Processes of societal individualization have reduced the power of traditional loyalties, and at the same time raised the level of expectations towards democratic polities. In this situation the reference to and conflict over basic principles of justice becomes critical. This is especially the case now that in all advanced societies the institutional patterns of resource distribution are under stress, and the public agenda is dominated less by the prospect of giving new benefits to the citizenry than by the retrenchment of existing ones (Liebig *et al.* 2004).

Public issues of ageing are above all issues of social security and the welfare state. This may be the arena where the reference to principles of justice is most marked, because it is here that the problems of the societal distribution of

resources are to be resolved. The welfare state directly bases its legitimacy on principles of just distribution, and therefore its legitimacy is especially dependent on whether it is perceived as fulfilling these principles.

Justice beliefs and attitudes<sup>2</sup> are thus critical because at the collective level they condition the public acceptance of welfare state reforms (and by that, the latter's political fate). They are moreover critical because at the individual level they affect compliance with the taxes and contributions imposed by the welfare state.

The relevance of attitudes may be questioned on two grounds. The first is the possibility that the opinions of ordinary people will be unsystematic and contradictory. The second is that it is not clear to what extent attitudes are in line with actual behaviour. These are both potentially serious drawbacks, which is especially clear in relation to the large body of scholarship in the philosophy or political theory of justice, i.e. in the normative arguments on what is to be considered just on what grounds. It can be shown, however, that the popular beliefs at stake here are indeed reasonably well structured, and reasonably well in line with systematic discussions of distributive justice (Swift *et al.* 1995: 35). And while attitudes or beliefs do not by themselves determine behaviour, they do provide relatively enduring predispositions to action, albeit leading to different behavioural outcomes in different situations (Swift *et al.* 1995: 41; see Kohli 2006 for a broader discussion).

The literature on distributive justice shows convergence on some broad conclusions. There are three basic principles by which distributive outcomes are justified: need, merit or desert (usually based on work performance), and equality (usually based on citizenship status). In addition to need and merit as criteria to justify an unequal distribution, one may also invoke the incentive criterion – inequality serving to motivate people to perform better so that in a positive-sum game everyone will be better off in the end. These principles operate at the level of normative theories (e.g. Miller 1999), at the level of popular beliefs (e.g. Forma and Kangas 1999; Swift *et al.* 1995), and at the level of welfare state institutions (e.g. Leisering 2004; Palme 1990; Rothstein 1998). Their salience varies between countries, between groups of persons, and between the parts of the welfare state, but together they seem to exhaust most of the conceptual and empirical space of distributive justice.

For the specific topic of justice between age groups and generations, we first of all need to remind ourselves to analytically separate these two dimensions. As Daniels (1988) has shown, inequality among age groups – based, e.g. on needs perceived to be different – does not violate justice principles (as unequal treatment based on other 'morally irrelevant' traits such as gender or race would). The reason is that while we (usually) do not change our gender or race, we do change our membership in age groups by the simple process of ageing. Thus, the fact that we successively live through all the stages of life makes treating them differently morally acceptable. (For more precision, the argument has to take into account differential longevity structured along relevant socio-demographic group characteristics. Indeed the question of whether groups with shorter life

expectancy – e.g. lower vs. higher status groups, or men vs. women – should help finance the benefits for those living longer has become a pressing issue of relating *inter*-generational with *intra*-generational equity.) There may be grounds for justifying a distribution according to the different needs of age groups, e.g. children versus adults or the elderly. They are institutionalized in practices such as income equivalence scales which often assume lower costs for children (but usually do not differentiate among adults of different ages). On the other hand, there may be grounds for allocating more resources to children – more precisely, families with children – because, for example, of a perceived need to invest into a society's future (see Esping-Andersen *et al.* 2002; Esping-Andersen 2005; Preston 1984). There is also the heavily-discussed issue of singling out age groups by ascribing them different levels of 'merit', such as through rationing access to some forms of medical treatment for older persons (see Callahan 1987). But usually it is most appropriate to have equality across age groups. The 'prudential life span account' proposed by Daniels (1988) as a normative standard seems to ultimately favour equal outcomes. And indeed it can be observed that special benefits for one age group – e.g. free or subsidized access to public transports or cultural events – are usually legitimized in terms of making up for the disadvantaged economic situation of this group rather than of different needs.

The domination of the equality criterion is even clearer for the distribution across generations. It may be questionable how far into the future (or into the past) the standard of equality should be extended, but there is little ground for legitimizing any other distributional standard. The inter-generational sharing of burden and rewards is just or fair to the extent that each successive generation can expect to receive the same treatment as the preceding and following ones when it moves up through the stages of life. In such a world, financing the elderly during one's earning years through a pay-as-you-go system is not problematic because one can expect to reap the same benefits in one's retirement funded by the next generation (a pattern often called *indirect* or *sequential reciprocity*). Problems arise 'only' to the extent that such equality of treatment is not given – which, in the real world, is unfortunately rather the rule than the exception.<sup>3</sup>

This is where the discourse of generational equity has kicked in (see the overview by Williamson and Watts-Roy 1999; also Binstock and Quadagno 2001). Its origin lies in the US. During the 1960s and 1970s the US enjoyed a period of expansion of social security for the elderly under the banner of what Binstock (1983) described as *compassionate ageism*. This idea of the elderly as discriminated against, poor, and in need of public support proved to be 'an effective rhetorical device ... [that] helped sell social policies that increased the share of societal resources' allocated to the elderly (Williamson and Watts-Roy 1999: 10). The turn away from compassion for the old had to do with the success of these policies in changing their economic situation, with changing demographics, and with the economic downturn of the early 1970s. But these changes in the 'real world' needed to be discursively focused and packaged in

order to become politically effective (see also Chapter 4 in this volume). This was achieved not least by a number of conservative think tanks and foundations. The media have become the central arena for the construction of political meaning, favouring through their rhetorics not only individual actors but also 'flamboyance, simplification, polarization, and the related styles that emphasize the crisis nature of social problems' (Williamson and Watts-Roy 1999: 26).

The key claims of generational equity are that the elderly benefit from an unfair distribution of public resources (for pensions, healthcare and social services), and that this comes at the expense of the non-aged population, especially children. These claims have been anything but new, but their growth into a full-blown political discourse can be dated to 1984, with on the one hand Preston's (1984) influential comparison of the wellbeing of children and the elderly, and on the other, the founding of *Americans for Generational Equity* (AGE).

From the US the discourse has been imported to the UK and to the European continent where institutionalization has been slower but with more current weight, such as with the German *Stiftung für die Rechte zukünftiger Generationen* (Foundation for the Rights of Future Generations) founded in 1996. The different patterns of debate in Europe can be attributed to its institutions as well as to its discursive traditions. In fact there are also major differences within Europe. As Schmidt notes, inter-generational justice has become a recurrent theme 'only in those Continental countries with pay-as-you-go, earnings-related pensions, where the problems of funding remain significant – for example, in Germany, Austria, Italy, Belgium, and France – and not the Netherlands or Switzerland' where pensions are to a larger extent privatized (Schmidt 2000: 302).

The discourse of generational equity has clearly been one of the more effective ones in shaping the public agenda of welfare retrenchment over the last two decades. Its effectiveness in changing popular attitudes is another matter (see p. 206). The political consequences drawn by the proponents of generational equity go in the direction of reducing public spending for the elderly – e.g. by privatizing (parts of) old-age security, reducing the benefits and increasing the retirement age. Other demands include age-based rationing for some types of medical care, and age tests for a range of issues such as driving or even voting. More recently, there have been proposals to extend voting rights to children (in other words, to give their parents more votes), and to make pension contributions and benefits contingent on the number of own children. In Europe, the demands are often grouped under the term *sustainability*, which links the long-term survival of social security schemes to issues in the domain of ecology.

Although the general idea of keeping the world intact for future generations is readily accepted, the more specific demands have drawn intense criticism. Among the scientific community of gerontology and the associational community of old-age concerns, the generational equity demands have become a common rallying point for repudiation and indignation, and an easy target for claiming the scientific and moral high ground. These counter-statements have indeed made a strong case, pointing out that the expansion of old-age security



should be seen as a success that – far from unduly privileging the elderly – has only given them their due share by finally bringing them up to par with the active population (Hudson 1999). Moreover, improving their wellbeing does not necessarily come at the expense of other population groups. The argument of a zero-sum game in the distribution of resources between young and old can be criticized on three grounds: first, children and the elderly depend on different institutions for their economic wellbeing (Easterlin 1987); second, if seen in a comparative perspective higher public spending on children and elderly are not mutually exclusive (Pampel 1994); and third, children and the elderly are linked through inter-generational family ties so that resources flowing to one side profit the other as well (Kohli 1999).

Finally, the institutional alternatives to public social security are less convincing than they are discursively made to look (see Chapter 8 in this volume). For example, privatizing old-age pensions through a fully funded system will not solve the problem of lower returns since returns from private funds depend equally on the domestic economic product at the time they are cashed in (except to the extent that the funds are invested in more dynamic economies abroad). The costs of private funds – in other words, the profits to be made for the financial industry – are often much higher than those of public administration. Predictably, a mature privatized system such as that of Chile is now facing these problems.

In the US, reframing the discourse of generational equity as a fiscal ‘entitlement crisis’ has also been less than convincing (Quadagno 1996). It suffered its first blow through the disappearance of the federal budget deficit in the late 1990s. In the meantime the deficit has skyrocketed again under the combined pressure of the Bush administration’s tax cuts and the costs of war. (For the latter there are obvious parallels to the early 1970s.) The administration’s attempts to resurrect the entitlement crisis frame by shifting the blame for the deficit to social security have so far not succeeded.

European welfare states, however, have been less fortunate. Here, the issues of generational equity have become an important part of the broader efforts towards welfare retrenchment (Esping-Andersen *et al.* 2002; Pierson 2001). This is due to the tightening of public finances under the pressures of Europeanization and globalization, but also to the increasingly bleak demographic outlook. Demography is not destiny (and presenting it as such may be another form of ideology) – but it does create a major challenge in terms of population ageing. This challenge goes beyond the economically advanced societies of the OECD; it is, however, largest for some of the latter that have shown a persistent pattern of low fertility.

The joint impact of low fertility, increasing life expectancy and relatively early exit from the labour force will drive up the contribution rates or drive down the income replacement level of pensions, especially (but not only) in welfare states with extensive pay-as-you-go (contribution- or tax-based) pension systems. Immigration (see United Nations Population Division 2000), increasing female labour force participation and an increase in the retirement age limit will

all provide some financial relief, but the demographic numbers are such that the issues will remain critical.

Some proponents of generational equity argue that the window of opportunity for implementing reforms is closing because the older population increasingly dominates the political arena by its sheer voting weight. They see a point of no return when the power of the elderly will be such that they will be able to block any attempt at reducing their benefits. In a formal analysis for Germany, Sinn and Uebelmesser (2002) have projected the median age of voters and the 'indifference age' as the age of the cohort that is affected neither positively nor negatively by a pension reform. The assumption is that reform will be feasible if and only if the median voter favours it. The authors conclude that until 2016, a reform can be democratically enforced because a majority of the voters will still be below the indifference age. 2016 is 'Germany's last chance'; after that year, it will be a gerontocracy.

Such a model is of course highly mechanical; it presupposes that voting shares fully translate into specific policies, and that people's votes are based only on their current individual cost-benefit position – which is manifestly not the case (see p. 206). Pampel (1994) has shown that from 1959 to 1986, the effects of population ageing on public spending in OECD countries varied according to whether a country had class-based corporatism and strong leftist parties. Population ageing resulted in higher spending on pensions and the aged relative to spending on families and children only in countries (such as the US) without these features. Self-interested mobilization by age is thus more likely in countries which do not have class-based institutions that emphasize *intra*-generational over *inter*-generational cleavages and conflicts.

If political action is not purely interest-based, this creates room for discourse based on justice ideas. According to Daniels' (1988) argument presented above, inter-generational sharing of burden and rewards is just or fair to the extent that each successive generation can expect to receive the same treatment as the preceding and following ones when it moves up the through the stages of life. Unfortunately, the real world never quite conforms to this ideal. The most drastic departure from it may be illustrated by Thomson's (1989) account of the development of the welfare state in New Zealand. According to Thomson, it has been the result of the political activity of a specific generation which first created a youth-state with housing subsidies and benefits for young families, and then over its own life course turned it into a welfare state for the elderly. New Zealand's welfare state thus would have represented one generation's success in exploiting its preceding and succeeding ones.

Although such blatant political exploitation of the public 'generational contract' seems to be the exception rather than the rule, there are other sources of discontinuity. As mentioned above, the most obvious one today is demography. Some pension reforms (for example in Germany) now attempt an equitable response to this discontinuity through the introduction of a 'demographic factor'. A formal proposal for coping with the changing size of successive cohorts is the *fixed relative position* (FRP) model (Musgrave 1986) where

'contributions and benefits are set so as to hold constant the ratio of per capita earnings of those in the working population (net of contributions) to the per capita benefits (net of taxes) of retirees' (Myles 2002: 141). This allows for proportional risk sharing: the distribution of resources among age groups agreed upon in a society is stabilized so that it remains identical for each successive cohort, thus fulfilling the condition for Daniels' (1988) justice standard.

But problems of equity arise in the *intra*-generational dimension as well. The relation of the 'old' issues of inequitable distribution (or poverty, or exclusion) along class lines and of the 'new' ones such as those based on generations remains a thorny one. The discourse on inter-generational equity may function as an ideology: as a way to divert attention away from the still existing problems of poverty and exclusion *within* generations, e.g. based on class or gender. If welfare systems are redesigned as a consequence of demographic change, these problems may be exacerbated in surprising ways. An example is the proposed rise in the age of retirement. Given that longevity is socially stratified, a rising retirement age would disadvantage the less well off because an additional year of employment represents a larger proportional loss for someone with a shorter life expectancy (Myles 2002).

### Attitudes towards pension policy

Most of the claims of generational equity focus on the distribution of resources between the young and the old. The empirical record here is unequivocal (see Kohli 2006): The income position of the elderly has improved over the past decades in most countries but still remains below that of the active population. On the other hand, families with young children have lost ground, and are now considerably worse off than the active population in its entirety. An analogous pattern can be observed with regard to poverty rates. It is obvious from these results that in terms of generational equity (as well as of pronatalist incentives) families with young children should indeed be the target of supplementary welfare efforts. But the results provide no reason to strip the elderly of (even part of) their current benefits.

How do public attitudes reflect these issues? In addition to a range of national studies on attitudes towards welfare reform and generational equity, there are now several cross-national surveys that lend themselves to comparative analyses. The most comprehensive, in terms of the number and range of nations covered, is the *International Social Survey Program* (ISSP, e.g. Andreß and Heien 2001; Blekesaune and Quadagno 2003; Hicks 2001; Iversen and Soskice 2001; Smith 2000; Svallfors 2004; Taylor-Gooby 2001). This is a yearly survey with additional topical modules at larger intervals;<sup>4</sup> it currently comprises almost 40 countries (including most Western and Central European ones as well as Canada, Mexico and the US). Even more countries are included in the *World Values Study/European Values Study*, which however have only very few items relevant for welfare state attitudes. More restricted in scope but sometimes offering more detailed measurements are the *Eurobarometer* (e.g. European Com-

mission 2004; Kohl 2003a, 2003b; Lynch 2006; Walker and Maltby 1997), a regular European Union survey covering its member and candidate states which also has changing topical modules, and special surveys such as the *International Social Justice Project* (ISJP, see Kluegel *et al.* 1995) or the *International Survey of Economic Attitudes* (ISEA) (see Forma and Kangas 1999). The new *European Social Survey* (started in 2002/2003) now also yields its first analyses (e.g. Jaeger 2006).

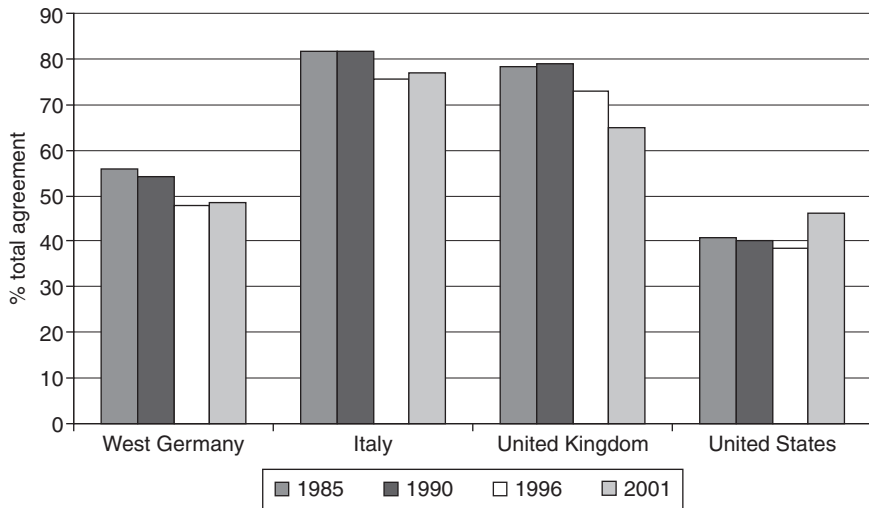
Three hypotheses put forward by the research literature need to be examined here:

- 1 To the extent that attitudes are shaped by public discourse, it is to be expected that they are critical of social benefits for the elderly, and increasingly so over the years.
- 2 To the extent that attitudes towards pensions are determined by current self-interest, it is to be expected that they show massive variation (a) between age groups and cohorts, and (b) along dimensions such as income.

The assumption that attitudes towards welfare spending are determined by self-interest underlies most economic approaches, and has also gained prominence in the 'new politics' literature of welfare retrenchment initiated by Pierson (1994). The latter claims that the welfare state has created large constituencies of beneficiaries who now oppose any cuts in the programmes from which they benefit – a policy feedback that drives politicians to blame avoidance. But there has been little support so far for an interest-based model of policy positions or voting behaviour, and little inclination to test the micro-foundations of the 'new politics' approach (Lynch 2006).

Several authors (e.g. Jaeger 2006; Lynch 2006) have noted that attitudes towards state responsibility for the old, the sick or the unemployed are massively positive (and thus show little variance). This contrasts with attitudes towards redistributive policies where there is more variation. The support for state responsibility is especially strong in the domain of old-age pensions. Most attitude studies up to now show a level of acceptance of public pensions that is much higher than the discourse on generational equity would lead us to think.

For a more detailed account, it is useful to start with attitudes towards social security more generally, and then proceed to those towards specific dimensions of pension reform. A first set of questions to be examined here is about which one among the different institutional systems or 'pillars' of the welfare mix should provide social security. On the issue of whose responsibility it should be to provide a decent standard of living for the old (ISSP 1996, see Hicks 2001), an overwhelming majority in all countries say that this should (definitely or probably) be the government's responsibility: from 84 per cent in Japan and 86 per cent in the US to fully 96 per cent in the UK and 97 per cent in Italy. The proportion of those stating that this should definitely be so increases over the life course, but even among those under age 30 it ranges between 38 per cent (in Canada) and 69 per cent (in Italy), while among those over 65 the range is from



*Figure 10.1* Views on responsibilities for a decent standard of living for the old, 1985–2001. Percentage indicating that it should definitely be the government's responsibility to provide a decent standard of living for the old (source: Hicks (2001) (based on ISSP 1985–1996), and author's calculations (based on ISSP 2001)).

42 per cent (in the US) to 81 per cent (in Sweden). As Hicks (2001: 8) concludes, this 'is not large enough to signal any intergenerational rift'. Contrary to what the lively public discourse in the US would suggest, the age gap is almost nonexistent in this country.

As Figure 10.1 shows, in the four countries for which consistent time series from 1985–2001 are available (West Germany, Italy, the UK and the US), support fell slightly until 1996, but again much less than the public emphasis on 'reform' in the sense of retrenchment would lead us to believe. Since 1996 it has even slightly increased again in three of the four countries, especially the US. It seems plausible to conclude that when old-age security is perceived to be in danger the responsibility of the state is affirmed more stringently.

A second question concerns the desired extent of public spending for old age security (see Hicks 2001: 11). The question wording takes pains to avoid making the response too easy by signalling that 'much more' spending might require a tax increase, but even so, between 7 per cent (in Canada) and 27 per cent (in the UK) say 'much more', and between 21 per cent and 51 per cent say 'more'. The large majority of the rest opt for 'same', between 1 per cent and 8 per cent for 'less', and only between 0 per cent and 2 per cent for 'much less'. Clearly, there is very little support for cutting old age benefits, and considerable support for expanding it.

Table 10.1 presents the data according to age groups. The desire to expand government spending on pensions increases somewhat with age, but less than

Table 10.1 Views on public retirement spending, 1996

*Percentage indicating they would like to see more, or much more, government spending on retirement benefits (being asked to remember that if you say 'much more', it might require a tax increase to pay for it)*

	<i>Age group</i>				
	<i>Under 30</i>	<i>30–39</i>	<i>40–49</i>	<i>50–64</i>	<i>65+</i>
Canada	34.8	23.4	24.6	30.5	20.5
Germany	45.5	41.6	41.6	48.4	51.7
Italy	55.8	60.4	65.8	65.8	75.6
Japan	54.6	48.0	53.9	57.9	60.9
Sweden	41.7	51.3	51.9	59.8	66.8
United Kingdom	63.3	79.2	79.7	79.8	87.1
United States	55.0	51.0	45.7	48.9	45.2

Source: Hicks (2001) (based on the International Social Survey Program).

expected, with the two North American countries even going in the opposite direction. Bivariate results such as these may obviously reflect compositional changes other than age. There is for example a gender gap (not shown in the table) which is the largest in Sweden and the smallest in Japan (see Hicks 2001: 20), with women having a higher preference for more public spending than men, which is partly behind the higher preference in the older age groups. More multivariate analyses will be needed to separate the various effects.

There is thus little evidence for the widely presumed loss of legitimacy of public social security, and especially pension provisions. Most people 'favour existing arrangements – whatever they happen to be. That is a realistic view in light of the success of those policies' (Hicks 2001: 4). What also needs to be noted, however, is a widespread loss of confidence that these existing arrangements will continue. It is in this sense of empirical prediction rather than political preference that the public generational equity discourse has been effective.

A special *Eurobarometer* module of fall 2001 (as analysed by Kohl 2003a, 2003b; see European Commission 2004) provides a more recent description of EU public opinion on these matters, with a wealth of items on specific pension goals and policy options. Goals refer to the normative preferences held by the citizens, in other words, to their underlying value orientations, and in particular their ideas of social justice (European Commission 2004: 44). The two most popular goals are prevention of poverty (92 per cent agree with the statement that 'the primary goal of a good pension scheme should be to protect elderly against the risk of poverty') and provision of basic social rights in the form of a guaranteed minimum pension (90 per cent). Maintaining an adequate living standard relative to one's income before retirement (88 per cent), greater equality among the elderly (84 per cent), and the pay-as-you-go principle (81 per cent) are also supported by more than four-fifths of the population.

Country differences in these normative preferences are not very marked.

‘There seems [to be] a broad consensus amongst European citizens concerning the goals of pension policies and even about the prioritisation of certain goals’ (European Commission 2004: 7). This is held to be good news for the proponents of a common EU social policy, showing that ‘the value orientations and the social policy attitudes of citizens in the EU member countries do not fall as far apart as the institutionalised forms of social security do (especially in the field of pensions)’ (p. 7). This is in line with many other studies that have not been able to show a clear correspondence between welfare state regime types and attitudes (see Jaeger 2006).

As to age differences, the support for most of the statements shows an age trend in the expected direction. ‘The magnitude of this age effect, however, is not very significant’ (Kohl 2003a: 14). The strongest age difference concerns the pension entitlements of homosexual couples – and this is clearly not an age effect related to economic (self)-interest but a cohort effect related to value change.

Figure 10.2 shows support for three alternative proposals for balancing revenues and expenditures of public pension schemes. To raise awareness of the costs of each option, the trade-offs were explicitly mentioned in the alternatives posed:

- 1 Current benefit levels should be maintained, even if this means increasing contribution rates or taxes;
- 2 Contributions should be maintained, even if this means lower pension benefits;

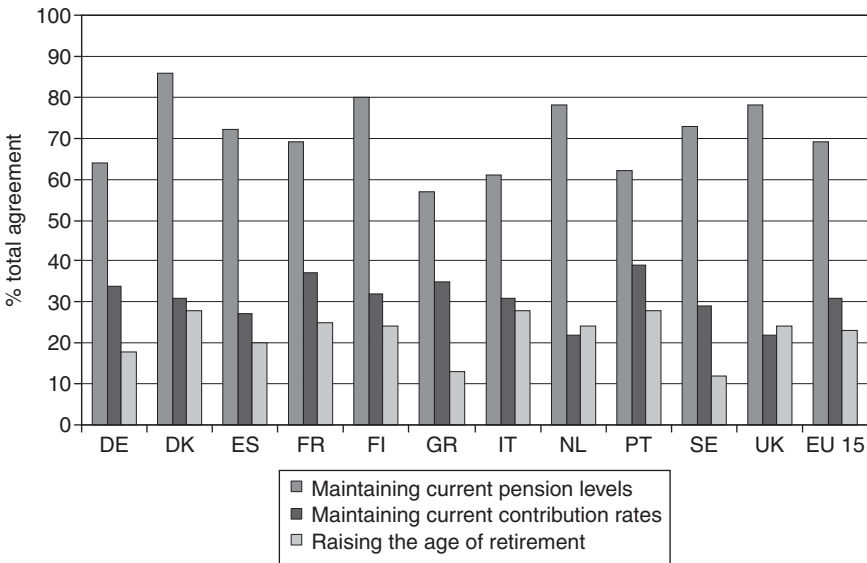


Figure 10.2 Support for pension policy alternatives, 2001 (source: Kohl (2003b) (based on Special Eurobarometer 161)).



- 3 The age of retirement should be raised so that people work longer and spend less time in retirement.

The first option, maintaining current pension levels, gains majority support in all EU member states. In the EU as a whole, 30 per cent strongly agree and 38 per cent slightly agree with this statement, while only 5 per cent strongly disagree and an additional 15 per cent slightly disagree. In contrast, the second option, maintaining current contribution rates, is supported by only 31 per cent and disapproved by a majority of EU citizens (53 per cent).

The third alternative, raising the age of retirement, is clearly the least popular one. Only 23 per cent approve it, while there is strong disagreement for 40 per cent and slight disagreement for an additional 29 per cent. If working longer turns out to be inevitable, such a policy will have to overcome considerable popular resistance. It may be true, as Hicks (2001) maintains, that there is 'no opposition to working later in principle – people would like to work at older ages if the work were enjoyable' (p. 17; see Kohl 2003b: 14, for a similar point). However, apart from the issue of how widely available such enjoyable jobs are, there is also the issue of control and choice. Raising the age of retirement would mean a longer dependency on whatever the labour market offers, and fewer resources for freely choosing between work and retirement. Does this mean that ordinary people are so stubborn that they will never give up their privileges? This is clearly not so. It means that they will have to be convinced that their sacrifices are necessary, that institutional retrenchments will be implemented with circumspection, and that they will be balanced by labour market reforms in favour of elderly workers.

The first option (maintaining current benefit levels) places the burden mostly on the tax payers or the active labour force, the second (maintaining current contribution rates even at the expense of lower pensions), on the pensioners. But this again does not translate into massively different rates of support by age. There is some tendency for pensioners (76 per cent) to prefer the first option more often than the 'active' population (i.e. those in the labour force), but even among the latter, a strong majority (66 per cent) support maintaining current benefit levels even at the cost of rising contributions. Raising the retirement age is rejected by 69 per cent of the retired as well as the non-retired part of the population.

These results demonstrate that the distributional conflict among generations is much less pronounced than is presumed (or advertised) by the proponents of generational equity. There is some differentiation along the age dimension, but much less than one would expect from an interest-based model of political preference. This is true even for the more recent measurements. We may be on the brink of change – but if so, it does not yet show in the available data.

As to intra-generational conflicts, two results are worth mentioning here. Lynch (2006) has tested the hypothesis that welfare programme beneficiaries are the main supporters of such programmes by contrasting the attitudes of public pension beneficiaries with those of elderly people whose income does not

depend on public pensions, and finds no difference between the two groups. Iversen and Soskice (2001: 885) show in a pooled analysis across ten Western countries (based on ISSP data for 1996) that support for social spending is mostly explained by income – it accounts for between 11 and 51 per cent of the explained variance in their model (with a total adjusted  $R^2$  of 0.22), depending on whether it is introduced as the last or the first variable in the model – and skills composition (between 26 and 38 per cent). In contrast, age is a much weaker predictor of support for social spending, accounting for between 1 and 2 per cent of the explained variance.

### **Towards an explanation**

With regard to the hypotheses formulated at the beginning of the previous section, we have found a large discrepancy and even contradiction between public discourse and popular attitudes. The expectation that attitudes follow discourse has received little support. The same is true for expectations based on a narrowly conceived individual interest model of attitudes. Its prediction that attitudes towards pension policy would exhibit massive cleavages among age groups and generations has not been corroborated. On the other hand, there is some evidence for the continued influence of the ‘old politics’ cleavages of class.

How is it to be explained that age (and/or cohort) effects remain so modest? One reason lies in the institutionalized life course outlined earlier: individuals can expect to graduate to older age groups through the simple process of ageing. Among the young, support for the generational contract is likely to depend on whether they trust in its inter-generational neutrality and continued viability, so that they themselves will also receive its benefits.

A broader explanation, however, lies in the generational interdependence frame that has been raised in opposition to that of generational equity (Kingson *et al.* 1986; Williamson and Watts-Roy 1999). It emphasizes burden-sharing and solidarity between the generations, and also more tangible forms of support. On the other hand, it highlights problems of intra-generational equity as well. For the young, the institutionalization of income-maintaining retirement pensions means that they are freed from any expectation of income support towards their parents. They can moreover count on services such as grandparenting. But in many cases they can also expect material support. This private inter-generational exchange is facilitated and ‘crowded in’ by the public generational contract. The public resource flows to the elderly have enabled the latter to transfer resources to their offspring in turn.

Recent research on *inter vivos* family transfers demonstrates that such transfers are considerable, that they occur mostly in the generational lineage, and that they flow mostly downwards, from the older to the younger generations (Kohli 1999). There may be expectations of reciprocity, or other strings attached, but by and large parents are motivated by altruism or feelings of unconditional obligation, and direct their gifts to situations of need. As an example, the

German Ageing Survey in 1996 showed that 32 per cent of those above age 60 made a transfer to their children or grandchildren during the 12 months prior to the interview, with a mean net value of about €3,700. Thus, part of the public transfers from the active population to the elderly was handed back by the latter to their family descendants. The aggregate net *inter vivos* transfers by the elderly population amounted to about 9 per cent of the total yearly public pension sum. This link needs to be qualified, but the overall pattern is clear: the public generational contract is partly balanced by a private one in the opposite direction. The family transfers function to some extent as an informal insurance system for periods of special needs. Even more important in monetary terms are bequests. They are more frequent and much higher in the upper economic strata, but now also increasingly extend into the middle and lower ranks.

Another issue is how welfare benefits are distributed between the age groups. As Lynch (2001) shows, some welfare states – such as Italy, the US and Japan – orient their social spending heavily towards the elderly, while others have a more balanced spending pattern. Here again, however, it is the inter-generational links that matter. Despite the extensive comparative literature on old-age security and related programmes, the institutions that shape the politics of ageing societies – and by this, the way that generations are able to relate to each other – have mostly been neglected so far. We need to examine the institutional patterns – such as those of parties or unions (Pampel 1994; Kohli *et al.* 1999) – that mediate generational conflicts by favouring or disfavouring age integration in the political arena.

Our discussion has shown that the potential for distributional conflicts among generations certainly exists and is fuelled by the current challenges of public finances and demography. However, the discourse of generational equity overstates the extent and inevitability of such conflicts, and sharpens them at the expense of conflicts along the more traditional cleavages of class. Survey data regularly show that the public generational contract still enjoys high legitimacy among all ages and segments of the population, and that pension reforms that cut into existing benefits are highly unpopular.

The question remains whether these attitudes make a difference in the political process. Professional political actors may not always be aware of the survey results but they are (more or less effectively) exposed to popular beliefs through other channels of communication. As an example, political attempts to raise the retirement age, or more precisely, the age of access to public pensions, have met with open resistance from labour-based constituencies, so that such reform attempts have usually been quickly watered down or even completely withdrawn. But the ‘new politics’ assumptions of a tight feedback between benefit status and attitudes are mistaken. The constituencies of the generational contract may be convinced of the legitimacy of pension reform. This, however, will require a discourse of intra-generational burden sharing and inter-generational linkages.

## Notes

- 1 This chapter is partly based on a recent overview of justice theory and justice research as they relate to ageing and generations (Kohli 2006).
- 2 Even though beliefs and attitudes may be differentiated in terms of cognitive structure, the two concepts are used here interchangeably.
- 3 Criteria of need or merit come into play with reference to *intra*-generational justice, as, for example, with the idea that the pension system should conserve the level of income that the individual achieved when in the labor force (merit), or conversely, that it should ensure a basic income floor (need). The first of these ideas is central to the Bismarckian welfare state, the second one to the Beveridgean in both its 'social-democratic' (universalist) and 'liberal' (residual) variant. Most empirical welfare states currently have some combination of the two, as when an income-maintaining pension system is complemented by a minimum guaranteed pension for those below a certain threshold (see Chapter 6 in this volume).
- 4 The most relevant module for the issues at stake here is *role of government*, last included in 1996 and again in 2006. Some questions have also been asked in other years (e.g. 2001).

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