The impact of Europe

The (once) unlikely case of old age pensions

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Abstract
The paper ties into the debate on the impact of the European Union on national policies. It focuses on the relatively under-explored sector of old age income security. Four developments are analysed: (1) from public to private pensions, (2) from unfunded to funded pensions, (3) from defined benefit to defined contributions, (4) from 'draconian' regulation to 'prudent men' regulation. Based on a preliminary analysis I argue that these current trends in old-age income security sector are at least partly shaped by European integration, sometimes in conjunction with economic and financial internationalisation. I also claim that the current developments may result in more EU influence in the future.

1 Introduction

In the last couple of years many (comparative) case studies have been published on the impact of Europe on national polities, politics and policies (see for an overview Börzel and Risse, 2000; Haverland, 2000a; Hix and Goetz, 2000; Radaelli, 2000). A sector that has received relatively less attention is old-age income security. To be sure, the most visible and direct effect of EU initiatives on old-age pension arrangements, EU policies aiming at gender equality in pay, has attracted significant scholarly attention (cf. Eylenbosch and Verreth, 1996; Leibfried and Pierson, 2000). Moreover there is currently some work going on focusing on the EU impact on *public* pensions (e.g. Anderson, 2000; Marier, 2000). Still the field remain relatively under-researched in particular if one takes the whole sector of old-age income security into account, including public, occupational and individual pension systems.

The relative lack of research on old-age income security can be largely explained by the fact that this sector was a rather unlikely case for European Union impact. Poverty alleviation and income maintenance for the old age has been at the core of the national welfare state and a major source of its legitimisation (Flora, 1986/1987; Swaan, 1992). Therefore, member states have been very cautious to delegate pension competencies to EU institutions. Moreover it is well known that the EU lacks the financial resources for large-scale redistributory policies. European policy-making is therefore largely regulatory policy making (Majone, 1996).

The paper argues, that there are currently developments taking place in the sector of old-age income security, which are at least partly driven by European integration and which will in turn make the sector more susceptible to EU influence.

The paper focuses on four developments (1) from public to private pensions, (2) from unfunded to funded pensions, (3) from defined benefits to defined contributions, (4) from 'draconian' to prudent men regulation. The evidence presented is rather preliminary for two reasons. First, the findings stem from an ongoing research project in which the development from the positivist - taxing and spending - welfare state for the elderly to a regulatory welfare state will be analysed (cf. Majone, 1997). Secondly, the project focuses on a rapidly moving target. The German government, for instance, has just adopted the most radical pension reform since 1957. Another example is the proposed European Union directive on pension funds (see below).

2 Developments in old age income security

2.1 From public to private pensions

In the course of the golden age of the welfare state, European governments of all colours gradually but continuously broadened coverage, reduced the legal retirement age and increased the replacement rates of their public pension arrangements. Public pensions account for some 85 to 90 per cent of all pension income in the European Union. This general development obscures, however, an important distinction between two types of pension arrangements that have resulted in different public-private mixes.

The Beveredgian countries have basic pension systems that provide flat rate benefits to all its citizens. Among these countries are Australia, Denmark, the Netherlands, Switzerland and the United Kingdom. The Bismarkian countries provide earnings related benefits on the basis of the working history, among them are Austria, Belgium, France, Germany, Italy, and Spain. While the main goals of the Beveredgian schemes are national solidarity and the alleviation of extreme poverty among the elderly, the main goal of Bismarckian arrangements is income (and therewith status) maintenance.

Beveredgian countries have generally a larger second pillar than Bismarckian countries.[1] This is mainly because of the flat rate character of the Beveredgian system,

[1] It is common usage to make a distinction between three pillars, or tiers, of old-age income security. The first pillar is made up of public pension schemes. These schemes are typically financed by taxes or social contributions (pay- roll taxes) on a pay-as-you go (PAYG) basis. In a PAYG system pensions

which is less satisfactory for middle and higher income groups. The first pillar in these countries cannot guarantee the maintenance of their standard of living. Accordingly, the flat rate character of the basic pension scheme resulted in strong pressures of employees for supplementary pension schemes (cf. Haverland, 2001; Myles and Pierson, 2001).[2] In Denmark, the Netherlands and Sweden supplementary schemes were negotiated by trade unions and employer organisations for the whole sector (or even above sector-level as in Sweden), reflecting the corporatist policy style in these countries. In other countries occupational pensions were company based. In Switzerland, participation in an occupational pension scheme was made compulsory, while in the United Kingdom it is at the discretion of companies to offer occupational pension schemes. Due to different levels of the basic pension scheme and due to different regulations about the set-up and access of occupational pension schemes, the coverage rate varies between the Beveredgian countries but is usually higher than in the Bismarckian countries (see Table 1).

As occupational pensions are typically funded, the scheme benefits not only from contributions by employers and employees but also from returns of investments. Due to flourishing capital markets in the 2nd half of the 1990s, the value of pension funds increased considerably. Beveredgian countries benefited in particular from this development, because of the high coverage in these countries (see Table 1).

are paid from current contribution payments, predominantly out of domestic labour income. Each generation finances the pension income of the previous generation on the understanding that its own pensions will be financed by the next generation. This constitutes an implicit social contract. The second pillar consists of supplementary occupational pensions. Occupational pensions are part of the employment contract and are mostly funded. In the case of funded schemes employees (and employers) pay part of their (labour) income into a fund of financial assets. Retirement pensions are paid out of current capital income, originating from investment revenues (interests) and by selling assets. The third pillar is made up of individual voluntary pension savings (e.g. life insurances) which pay either a lump sum or annuities. These provisions are always funded. House ownership is another source of financial security after retirement.

[2] In addition, some countries like Denmark, Switzerland and the United Kingdom introduced supplementary earnings-related state pension schemes, financed by PAYG. However, these schemes were too meagre to reduce the demand for additional occupational schemes.

Table 1 Values of pension funds assets in selected European countries

	Assets as %GDP (1992)	**Assets as %GDP (1997/1998)**	**Assets per capita (1997/98) $'000**	**Coverage**
AUS	-	4	1,0	4
BEL	0,2 (1)	10	2,5	31
DEN	**14,7**	**89**	**31,2**	**80**
ESP	-	4	0,7	
FRA	3 (2)	6	1,6	10
FRG	4,8	12	3,5	46
ITA	0,9 (1)	19	4,3	5
NET	**45,9**	**141**	**35,5**	**85**
NOR	3,5	24	8,9	
POR	2,4 (1)	10	1,2	
SWE	**16 (2)**	**90**	**25,3**	**90**
SWI	**51,9 (1)**	**105**	**40,3**	**100?**
UKM	**52,2**	**86**	**21**	**70**

1992: World Bank 1994; 1998 Financial times 21.05.1999, Coverage (Kremers, 2000) (Beveredgian countries in bold),
(1) Include some publicly managed funds, (2) 1993, Davis referred to in (CPB, 1997).

With occupational pensions increasing in value and public pension schemes either maintained or retrenched, the share of occupational pensions income in overall pension income has increased in importance in the Beveredgian countries. According to World Bank projections the portion of average worker's old-age benefit deriving from the occupational pillar will be about 50 per cent in countries like Denmark, the Netherlands, Switzerland and the United Kingdom (Brooks and James, 1999).

In Bismarckian countries, it is up to individual firms to offer occupational pensions. Since state pensions are earnings-related and generally quite generous the incentive to participate in occupational pensions has been quite low. However, due to their foundation on PAYG financing, these schemes are extremely vulnerable to demographic ageing and unemployment. To maintain benefit levels either contribution has to rise significantly or state subsidies would have to increase. In contrast to countries like the Netherlands, the Bismarckian countries had not the possibility to gradually shift the responsibility for old-age income security to the private (occupational) pillar without serious electoral repercussions. Still, some Bismarckian countries have recently started to join the Beveredgian countries on their path towards more private pensions. Germany is one of them.

Germany entered the era after the golden age with one of the most generous public pension systems in the world. From the mid- 1970s on it engaged in incremental reforms that culminated in a more radical reform in 1989. However, re-unification, high unemployment and demographic ageing kept pensions on the political agenda. After some - partly reversed - retrenchment measures in 1996 and 1997 by a Christian democratic-Liberal government, a Social democratic-Green government enacted in May 2001 the most radical pension reform since 1957. The reform had two main elements: retrenchment of public pensions and tax support for (funded) private pensions. According to the new pension benefit formulae the benefits for the average pensioner with a working history of 45 years (the so-called standard pensioner) will be gradually reduced from 70 to 64 per of the average wage of all insured. Moreover, for the first time in German history, the structural deficiency of the PAYG system - that is, its vulnerability to demographic ageing and inactivity - has persuaded a major government party to agree on a partial transition to funding. Employees are asked to save privately, starting with 0,5 per cent of the gross wage in the year 2001 and reaching 4 per cent in 2008. These savings will be supported by generous tax subsidies if certain financial instruments such as private pension insurance or occupational pension funds are chosen.

Though the causal mechanisms has still to be established by intensive process tracing it is likely that this solution to the problem of demographic ageing and inactivity, is heavily influenced by economic and financial internationalisation (cf. for Sweden and the Netherlands Anderson, 2000). Internationalisation seriously constrains the options available to policy makers. Increasing employer contributions harms the competition position of the domestic industry; increasing debts are likely to be punished by the international capital market and may endanger the Maastricht convergence criteria. Accordingly, the additional costs caused by demographic ageing and inactivity have to be paid by employees or at least out of general tax income. Germany is a good example for this. The whole policy was geared towards broadening the financial base and curbing the employer contributions. Already in the 1990s, additional resources were generated by increasing the state share in pension financing, partly financed by additional income from consumer taxes; by rising the value added

tax and introducing an ecological tax.[3] The 2001 reform places the burden of the additional savings on the employees, and - because of the tax subsidies - on all taxpayers.

It can be argued that even in traditional welfare states as Germany, the reform is only a first step to a much larger privatisation of old-age income security. As citizens turn increasingly to private solutions, solidarity for collective arrangements may erode further. This process might accelerate in those Bismarckian countries that are members of the European Monetary Union, (e.g. Germany, Italy, and France). As the March 2001 Council meeting in Stockholm documents, EMU members that are in a comparatively better position like the Netherlands have already joined forces with the European Commission to pressure these countries to reform the public pension systems. It is argued that without radical reforms, demographic ageing will force these countries into higher public debts, which will exceed the Maastricht criteria and will make a common monetary policy harder. The resulting inflation would in turn hollow out the pension funds that play such a prominent role in Beveredgian countries, as capital funding is vulnerable to inflation (Financiël Dagblad 27.3.2001).

To be sure public pension reform is predominantly a domestic affair, European Union social security competencies are weak and the European Court of Justice has largely protected the national legal authority in the field of solidaristic social policy arrangements (Leibfried and Pierson, 2000). Note, however, that it was agreed at the Stockholm Summit of the European Council that "where appropriate, the potential of the open method of coordination should be used to the full, particularly in pensions, taking due account of the principle of subsidiarity" (European Council, 2001, Rn 42). This rather soft method of integration has already been introduced at the Lisbon Summit (2000) for the area of poverty and social exclusion. It includes guidelines; short, medium and long-term goals; timetables; indicators and benchmarks in order to compare best practise; the national and regional translation of these European targets and regular monitoring, evaluation and per review (De la Porte and Pochet, 2001, 13).

[3] Note that through rising consumer taxes also those formerly not contributing to the scheme have to share some of the burden, including the civil servants, the self-employed, and the elderly themselves.

It is rather unlikely, however, that such rather symbolic pressure will make a difference to domestic politics as such. It can become important, however, when it is utilised by domestic policy makers in favour of reforms arguing that the European Union requires reform. Reform-oriented governments will probably use the opportunity to share the blame for cutting public pensions with "Brussels". This has already happened in Italy (Ferrera and Gualmini, 2000)

2.2 From unfunded to funded pensions

Public pensions are mostly based on PAYG and therefore unfunded.[4] But there are also some private pensions that are not based on funding. The French private occupational scheme is based on PAYG. Also, in a number of countries including Germany, Austria and Japan a large part of pensions are paid out of book reserves (cf. Turner and Watanabe, 1995). In Germany, for instance, the most important type of occupational pensions is the so-called direct commitment. Pensions are provided directly by the employers financed by book reserves, a commitment by the employers to pay pensions out of reserves (cf. Ebbinghaus, forth.). This type covers 75% of all participants in occupational pension schemes. Book reserves became prominent in countries like Germany, Austria and Japan because the tax system provided an incentive for them. They are in effect a cheap source of financing for the company (CPB, 1997, 241; Turner and Watanabe, 1995). Especially in the years of reconstruction, German companies were keen to use these schemes as an instrument of internal financing (Schmähl, 1997, 110).

Book reserves may have had advantages in a situation of weak capital markets. However, investing pension savings in mature, existing firms runs the risk of an inefficient allocation in the European capital markets, which will become increasingly integrated within EMU (CPB, 1997, 248-9). In addition, companies with too much unfunded pension liabilities (book reserves) might have problems to issue corporate debt. "Experts argue that if Germany want to issue corporate debt, borrowers will demand disclosure of full pension fund liabilities. This will not made pretty reading (in

[4] There are some notable exceptions. For instance the Swedish earnings-related second tier of public pensions is partially based on funding.

cases of book reserves, M.H) and may add to the pressure on companies to move to a funded basis" (Financial Times, 21.05.1999).

In a period of demographic ageing and integrated capital markets, unfunded pensions are becoming increasingly unpopular. Consequently, some German large companies have already announced to establish pension funds among them Volkswagen (Financial Times Deutschland, 7.12.2000). It is against this general background that in the recent German pension reform exclude book reserves from the additional tax support. More generally speaking, the stimulation of pension funds at the expense of book reserves is an explicit strategy to strengthen the German capital market. The government estimates that the recent reform will increase the private pension market by some 70 to 100 billion German marks annually (Sueddeutsche Zeitung 2.2.2001).

2.3 From defined benefit to defined contributions?

While individual pension schemes (third pillar) are always defined contribution schemes, occupational pension schemes (second pillar) can be either defined contribution or defined benefit schemes (Myles and Pierson, 2001; Queisser, 1998; Turner and Watanabe, 1995). In defined benefit schemes (DB), the sponsor of the scheme (usually the company) makes a promise to provide beneficiaries with a certain level of benefits upon retirement. Contributions are calculated accordingly. The risk lies with the sponsor. In defined contribution schemes (DC), the future benefits depend on contributions and the performance of the pension fund. Hence the employee has to bear the risk. Most occupational pension schemes in most OECD countries are DB schemes. Denmark and Switserland are among the few where DC schemes are in the majority (cf. OECD, n.y., 26).

In DC plans workers are immediately owners of the accrued benefit rights and funds can relatively easily be transferred. Portability is more difficult in DB schemes, because if many workers leave a company and are entitled to all contributions made by themselves or on their behalf, funded DB schemes which usually rely on risk pooling can have problems of underfunding. Due to increased (international) labour mobility,

especially within the European Union, DB schemes may come under strain if defined benefit rights are easily portable when a worker transfers from one company to another. This process is already under way as many countries reduced the barriers to the portability of benefits, among them Germany.[5] Spill-overs from market-building efforts in regard to the free movement of labour in the EU may further strengthen this development in EU countries. Consequently defined benefit schemes may make place for the less-solidaristic defined contribution schemes. In this case, redistribution implied by risk pooling would disappear, European citizens would be increasingly exposed to market forces (Jousten and Pestieau, 2000).

2.4 From quantitative restrictions to prudent men?

The investment and management of pension funds can be guided either by the so-called prudent man (or prudent person) rule or by the more 'draconian' asset restriction approach (cf. Kremers, 2000; Queisser, 1998). According to the prudent-man rule, the supervision authorities do not restrict pension funds investment policy *a priori*. It is assumed that money is invested "for the sole benefit of the beneficiaries" and that investments are made with "the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar such matter would use in the conduct of an enterprise of a like character and with like aims" (Davis, 1995). The prudent man rule is applied in English-speaking countries (Australia, Canada, Ireland, United States, and United Kingdom) as well as in the Netherlands and Belgium. The rule is mostly used to regulate DB plans where the risk that the target is not reached lies with the plan sponsor. For DC plans, particularly when they are mandatory, a more 'draconian' approach is commonly applied in order to safeguard the interests of the beneficiaries, examples are Denmark, Switzerland and Germany.

Pension supervisors issue investment regulation specifying the financial instruments that are authorised for investments (e.g. shares, bonds, and loans), and minimum or maximum quotas for the share of certain kind of assets in the overall

[5] An extreme case is - the non-member - Switzerland where full portability and immediate vesting were mandated at the beginning of 1995. A trend from DB to DC plans is visible in this country

portfolio. An import reason for maximum quotas is to safeguard the assets through diversification. One reason for a minimum quota which is not directly concerned with beneficiaries can be to help national governments to finance their debts (i.e. minimum quota for investing in state bonds) or more generally to keep capital in the country.

There are currently attempts for supranational regulation that may foster convergence towards prudent men regulation, irrespective of the type of funded scheme employed. The European Commission has proposed a directive that aims at promoting the free movement of capital and services in the area of pension funds: national rules that oblige pension funds to invest in national bonds have to be relaxed, more room for investing in stocks has to be created. The aim is not only to ensure that pension funds can invest freely anywhere in the EU, but also that they can use the services of approved managers in any EU state and ultimately cross-border membership (cf. Financial Times 21.2.1999). Not surprisingly, countries support this proposal that already have prudential men regulation in place, such as the Netherlands and the United Kingdom. Countries with more restrictive portfolio regulations are opposed to the directive, in particular some southern European countries. The proposal is also supported by the large internationally operating pension funds that became strong in domestic settings with large private pension markets and prudent men regulation. This holds for American and British funds but also for Dutch ones (NRC Handelsblad 27.03.2001). They find in their respective governments natural allies in this policy making process.[6] Also, many multinational companies, for instance those +/- 40 companies united in the European Round Table of Industrialists support the directive (NRC Handelsblad 12.10.2000). They would drastically reduce their transaction costs if they would insure all their employees in EU countries in one unified private pension scheme. Finally, the financial service industry has an interest in the directive as in an Europeanised environment pension funds need additional advice from specialists for their portfolio management (Ebbinghaus, 2000, 26).

(Queisser, 1998, 42).

[6] The largest pension fund in the world is ABP, the recently privatised Dutch public sector fund. Its assets are worth some 150 billion EURO. Roughly half of the portfolio is invested outside the Netherlands.

3 Conclusion

The paper has analysed four developments in the sector of old-age income security. They are shaped to a different extent by financial and economic internationalisation and European integration. The general trend towards private pensions has occurred against the background of economic and financial integration, including arguably European monetary integration that seriously has constrained the options available for national policy makers. Privatisation might accelerate when national policy makers can more credibly use 'Brussels' as a scapegoat. Financial integration in general, and in particular within the European Union, makes unfunded occupational pensions an increasingly inefficient solution. Companies in member states, which have traditionally relied on unfunded pensions, such as Germany, move towards pension funds. In Germany, this trend is reinforced by policies that stimulate funded private solutions.

Increased (international and European) labour mobility, facilitated by European and national policies, erode the basis of defined benefit schemes, resulting in more defined contribution schemes which place the risk of adequate income security on the employee. The European initiative to ensure the free movement of capital and services in the field of private pensions will probably result into a convergence towards the Anglo-Saxon 'prudent men' regulatory style. Initially designed for defined benefit schemes it may be increasingly applied to defined contribution schemes, which may increase the risk for European citizens, especially as consumer protection figures rather low in the Commission proposal.

It is important to note that the embryonic stage of the research project only allow for some general and preliminary results. In the next phase of the project an effort will be made to disentangle and differentiate the various international and European pressures on old-age income security. Moreover the mechanisms by which policy change comes about need to be further analysed, this includes the configuration of interests affected and the mediating institutional factors (cf. Börzel and Risse, 2000; Haverland, 2000b; Knill and Lehmkuhl, 1999; Knill and Lenschow, 1998).

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