

# The Role of Agenda Control in the Creation of a Single Market for Pension Funds

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## Abstract

Given the ideological and institutional differences between Bismarckian and Beveridgean pension systems, European efforts to develop a common pension market have proved a formidable problem for the European Commission. Why did pension market integration fail in the early 1990s but made a successful return onto the EU Commission's agenda more than a decade later? This paper argues that the creation of a pension fund directive in 2003, a crucial step along the way towards a single pension market, is not the result of neoliberal ascendancy, but the product of structural change and effective agenda-setting by the European Commission. The shift from an industrial to a service economy, as well as a range of pension reforms in Bismarckian nations, provided a window of opportunity for the Commission to invite member states to negotiate a single pension market. Secondly, learning from past negotiation failure induced EU administrators to use their agenda-setting tools more effectively, including limiting the range of policy issues under consideration, reducing uncertainty about member states' true reform types, and building coalitions with key member states.

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# 1 Introduction

In Kingdon's (1995) famous formulation, agenda control is "an idea whose time has come." The innovation that sweeps over existing patterns of policymaking is said to consist of several stages: (1) the setting of the agenda, (2) the specification of alternatives from which a choice is to be made, (3) an authoritative choice among those specified alternatives, and (4) the implementation of the decision (Kingdon 1995, p. 3). A productive stream of research has focused on the first two processes, generating important insights on why certain policies are seriously considered by political incumbents while several alternatives are ignored. However, the last two stages have received only scant attention. This omission is surprising, given variation in the effective use of agenda-setting tools.<sup>1</sup> A prominent place on a given policy agenda is no guarantee that an item will attain legislative passage, let alone implementation according to legislative intent. This paper seeks to understand agenda-setting in the context of pension market integration in the European Union. The goal of this paper is not only to explain how a "non-European" topic such as occupational pensions arrived on the supranational agenda, but also to specify the political and economic circumstances under which the EU Commission may use its agenda-setting tools effectively.

The existing literature usually attributes impasse between the member states to the unwillingness of major power holders to recognize the need for change because of commitment to a peculiar ideology, group benefits, or to the resistance of institutions (Jones and Baumgartner 2005). If the forces pushing for change are too weak, gridlock dominated by veto-players results. Yet, an exclusive focus on domestic institutions and cognitions in the member states ignores the possibility that the agenda-setting process itself may have been flawed, or that the economic environment in which bargaining took place may have been unfavorable for the issue under consideration. As Kitschelt has demonstrated, there are opportunities of "framing" policy issues that can make it easier for politicians to overcome resistance to change (Kitschelt 2001). Thus, the more interesting question is, which agenda-setting or manipulating tools are most effective in overcoming friction, given the existence of multiple veto-players both across and within member states? One way of studying this issue was proposed by Bachrach and Baratz in their seminal article *Two faces of power* (Bachrach and Baratz 1962). The authors suggest that powerful agenda-setting does not only manifest itself in key political decisions, but also in the ability to prevent decisions or contests from arising in the first place (Bachrach and Baratz 1962, p. 949).

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<sup>1</sup>One of the few pieces analyzing the effectiveness of agenda-setting in the European Union is provided by Tsebelis and Proksch. The authors attribute the successful creation of a European draft constitution to shrewd agenda-setting by the Convention president (Tsebelis and Proksch 2007).

We apply this approach to the analysis of pension market integration in the European Union. The dearth of research on common European pension policies is surprising, given the profound implications integration efforts in this sector have for national regulations of labor relations, capital flows, and social protection. More specifically, we ask why the initial attempt to pass a European pension fund directive failed in 1991, whereas a subsequent endeavor came to fruition in 2003.<sup>2</sup> We argue that the successful passage of the IORP pension directive in 2003 is not due to a diffusion of neoliberal ideas. An ideational consensus existed neither for the desirability nor institutional shape of a single pension market. Instead, we identify two factors, structural change and effective agenda-setting by the EU Commission, that are causally linked to the creation of the IORP pension fund directive. The difficulty of reaching a consensus was significant and the level of integration varies across issue areas. The knowledge of how it was done may improve our understanding of agenda control more generally, which was recently identified as one of the main challenges of research on the European Union (Princen 2007).

The following part outlines how structural change, in particular the shift from an industry-based to a service economy and recent pension reforms, lowered opposition of Bismarckian nations to European pension market integration. However, the story of structural change and economic integration is, on its own, incomplete, because it neither predicts legislative passage nor institutional design of EU directives. The ideas that eventually shaped the design of the pension fund directive diverged in many ways from those of neoliberal politicians, multinational companies, and like-minded EU bureaucrats. While economic integration provided the EU Commission with an opportunity to devote more attention to the issue of pension market integration, effective agenda-setting by Commission bureaucrats is causally responsible for the eventual adoption and design of the IORP directive. Highlighting the role of uncertainty and economic context in the agenda-setting process, the key claim is that the Commission's most effective manipulating tools included limiting the range of policy issues under consideration, reducing uncertainty about member states' true reform types, and building coalitions with key member states.

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<sup>2</sup>Directive 2003/41/EC, also known as the IORP directive (institutions for occupational retirement provision).

## 2 How did pension policies get on the European agenda?

“Pensions are not an EU responsibility, and a chapter on this topic as such may seem out of place.” The opening line of Pochet’s chapter captures the image of the proverbial man or woman on the street pondering the European dimension of pension policies (Pochet 2003). It is well-known that national governments are intensely jealous of their authority over social policy. Even though social policy autonomy is not an essential attribute of national sovereignty, welfare programs have long been regarded as a powerful tool of governments to assemble broad political support. This paper argues that recent developments at the European level jeopardize the Westphalian conception of pension policies, albeit only with regard to private and employer sponsored, but not social security, pensions. Thus, European pension policies may be understood as issues that are not “truly” European, but arrived on the agenda because domestic actors had a range of motives to push for consideration of the issue (Princen 2007, p. 34).

What is driving the development of European pension policies? Our argument differs from two rival hypotheses on cooperation in the international political economy literature. The first school of thought has identified a neoliberal policy consensus as the source of cooperative outcomes regarding European economic integration (Pauly 1997; McNamara 1998). McNamara traces the emergence of this ideational consensus to member states’ experiences with a series of macroeconomic policy failures in the aftermath of the first oil crisis, which weakened existing economic and social arrangements. A different account is provided by Abdelal, who also attributes international monetary cooperation to ideological change but rejects the notion that the liberal rules were written in the United States or Great Britain and only afterwards spread to Europe. Instead, he firmly locates the desire to liberalize international capital flows in the European member states themselves, contending that the decision of French bureaucrats to liberalize capital controls prompted the European Union, OECD, and IMF to compete with each other to control the issue area (Abdelal 2007, p. 31ff.). This paper shares Abdelal’s skepticism about the centrality of neoliberal ideas in shaping macroeconomic cooperation, as well as his confidence in the causal role of both member state preferences *and* supranational agenda-setting in shaping European Union politics.

The second line of research this paper challenges is the notion that left-wing efforts to build a “social Europe” are causally linked to pension market integration (Hutsebaut 2003). We do not dispute that social aspects of the IORP directive, such as the level of risk coverage pension funds should be required to provide, were frequently discussed in the European Parliament. However, the push for EU-wide harmonization of

pension regulations came from sectoral interests demanding a level playing field for fair competition in the area of occupational pension management. As financial market integration progressed, banks, insurance, and investment companies were granted permission to operate EU-wide on the basis of a single license. This measure prompted pension funds, represented by the European Federation for Retirement Provision (EFRP), to lobby for their own “single passport” to offset their competitive disadvantage vis-a-vis other financial service providers (EFRP 2001). Furthermore, multinational companies saw economies of scale if they could manage all of their employees’ pension claims in a single country, alleviating the need to familiarize themselves with social, investment, tax, and labor laws in fifteen member states.

### 3 The battle of the systems

While competition issues propelled pension market integration onto the European agenda, the creation of European pension market represented a classic cooperation problem: it was desirable in principle, but deep divisions over both goals and instruments of adjustment trapped member states in a political impasse. These divisions stemmed from the different philosophies and institutional structures underpinning Beveridgean and Bismarckian pension cultures.

Bismarckean governments found the construction of a common pension market politically more costly than their Beveridgean counterparts. Occupational pensions play only a minor role in Bismarckian nations, and any European-wide framework would put the domestic pension industry at a comparative disadvantage. Pension funds in these countries are typically subject to heavy regulatory restrictions and investment limits, making it difficult for the pension industry to develop or attract the asset–liability skills that are abundant in Beveridgean nations (Deutsch 2002). Furthermore, the lack of an equity culture tends to make both politicians and beneficiaries skeptical about any pension funding regulations, regardless of domestic or EU-level.

Beveridgean governments, by contrast, faced lower costs of reform. This is because their countries feature comparatively mature corporate pension systems, an internationally competitive pension industry, skilled asset-liability managers, and liberal investment regulations according to the prudent man rule. Occupational pension schemes rarely offer expensive biometric risk coverage (Blake 2003; Börsch-Supan and Miegel 2001; Davis 2000; Daykin 1996; Lynes 1997). While Bismarckian pension systems emphasize pension security,

pension policy in liberal states developed along different lines, with commercial and monetary interests dominating (Whiteside 2006, p. 44).

Given the divergent pension cultures these governments represent, they envisaged radically different versions of a European-wide framework. While Beveridgean member states preferred to implement the single pension market based on high harmonization of investment regulations, high harmonization of funding requirements, and no harmonization of biometric risk coverage, their Bismarckian counterparts envisioned the polar opposite: maintenance of quantitative investment limits, no harmonization of funding requirements, and high harmonization of biometric risk coverage. In short, the two types had different political ideal points corresponding to divergent levels of integration. The following section explores the sensitivity of governments and pension institutions to these tradeoffs.

## 4 Harmonization requirements for pension market integration

### 4.1 Taxation

The main barrier to pan-European arrangements is that tax deductibility for contributions to a foreign pension scheme is not allowed. Without a common taxation framework that prevents mobile employees from being double taxed – or from paying no taxes on retirement income at all – the movement of pension rights across borders will remain a chimera. Taxation of pension assets can kick in at three points: when contributions are made, investment income is paid, or pensions are disbursed. The international standard is taxation in the benefits phase, wherein only disbursed pensions are subject to taxation, but not contributions or investment return (EET approach: contributions exempt, investment income exempt, benefits taxed). The EU Commission initially recommended this standard for EU-wide adoption. However, major opposition to tax harmonization came from countries that do not tax pension funds on the basis of EET: Denmark, Italy, and Sweden have the ETT system (contributions exempt, taxed investment income and taxed benefits), and Germany and Luxembourg operate a TEE system (taxing contributions and exempting investment income and benefits). The fundamental reorganization of a country's tax system constitutes a prominent example of politicians' notorious difficulty to make intertemporal policy investments (Jacobs 2004). Reelection seeking incumbents are usually unwilling to take on the transitional costs associated with initial revenue losses involved in revamping the tax structure.

## 4.2 Investment rules

The second change the EU Commission proposed was the EU-wide adoption of the prudent man rule that prohibits pension funds from making risky investments. Yet pension funds in most Beveridgean nations already invest pension assets according to the prudent man rule, thus no adjustment costs accrue in this area. Yet, member states with Bismarckian pension systems found the creation of a European single pensions market politically considerably more costly than their Beveridgean counterparts. Pension funds in these countries are typically subject to heavy regulatory restrictions and investment limits, making it difficult for the pensions industry to attract the pension management skills it needs to be competitive (Estevez-Abe, Iversen, and Soskice 2001; Iversen and Soskice 2001; Deutsch 2002). In addition to the fear of foreign competition, Bismarckian countries justified the rejection of the prudent man rule – which for them meant investment liberalization – on the grounds that investors need protection against market risk, although the effectiveness of quantitative investment limits for reducing risk has been contested in the literature (Nürk and Schrader 1995). Restrictive investment rules are generally a reflection of a risk-averse society that lacks an equity culture. For example, before the adoption of the 2003 directive, British and Dutch funds were free to invest more than 5 percent of pension fund assets in any sponsoring company. German funds, however, had to meet no fewer than six separate limits: they could not invest more than 30 percent in EU equities, not more than 25 percent in EU property, not more than 6 percent in non-EU equity, not more than 6 percent in non-EU bonds, and not more than 20 percent in overall foreign assets. Thus, while Beveridgean nations lobbied for the EU-wide adoption of the prudent man rule, the Bismarckian nations wanted the opposite: casting tough investment restrictions in stone.

## 4.3 Biometric risk coverage

Another obstacle to cross-border pension movements included divergent regulations of biometric risk coverage. The percentage of the population that has access to biometric risk benefits varies considerably across countries, and within the same country, across different pension schemes. For example, while German pension plans routinely offer biometric risk coverage, British plan sponsors offer this coverage to a very limited extent, or not at all. In Britain, social policies enter the utility of employers with a negative sign because they do not fit with the high return/ high risk strategy British companies pursue. The provision of biometric

risk coverage raises the labor costs of companies, decreasing overall profitability. While Bismarckian nations sought to force the European pension industry to provide certain expensive pension products, Beveridgean countries wanted to leave that choice to individual pension institutions.

## 5 Uncertainty, learning, and reputational effects

The previous part demonstrated that the preferences of governments vary systematically with their exposure to welfare-finance reforms that the creation of an EU-wide pension market requires. How did this “battle of the pension systems” play out at the European level? Building on reputational models of repeated interaction (Tomz 2007; Drazen 2000, ch. 6), the following section develops a theory of cooperation that highlights the role of incomplete information and economic context in pension market integration. Standard political economy models that presuppose complete information about member state preferences leave no room for changes in impressions and therefore remove the possibility of learning or updating of beliefs. The theory advanced here allows beliefs about types to be updated over time, thereby accounting for feedback effects between EU Commission and member states.

The European Commission is the only institution that can propose legislation under the EU’s legal order, but proposals are not simply put to an up or down vote in the EU Parliament. To avoid the deeply embarrassing scenario of having to retract a proposal or being defeated in the formal decision-making process, the Commission has an incentive to assemble broad political support before a proposal is put to a vote. Yet this process, which typically entails informal deliberations prior to formal decision-making procedures, tends to be fraught with uncertainty: first, the Commission does not automatically know the most fruitful way of framing the issue under consideration in order to appeal to a broad majority. Secondly, each member state only knows its own capacity and willingness to reform, including the strength of institutional constraints and domestic veto players opposed to EU mandated change.

We assume that the true adjustment costs are private information of the respective governments. Because the costliness of adjusting domestic pension systems to EU mandated legislation is not directly observable from outside, governments have an informational advantage concerning their true reform types. This holds in particular for a government’s readiness to honor or default on debt obligations, of which pension liabilities



constitute the largest part. Even though member state representatives and EU administrators meet in a variety of places and have ample opportunity to exchange information, they have incentives to exaggerate the existence of domestic veto players and institutional constraints to get a more favorable deal (Putnam 1988). As many scholars have demonstrated, it makes a difference whether domestic constraints are perceived as real or feigned (Schneider and Cederman 1994; Bräuning, Cornelius, König, and Schuster 2001; Hug and König 2002). Furthermore, if there is no underlying consensus on the goals and design of the single pension market, member state representatives might disagree on the best alternative despite all of the relevant information being shared. Such systemic biases may induce negotiators not to fully disclose the severity of constraints they face at home (Austen-Smith and Feddersen 2006, p. 209).

We contend that EU Commission and member states form beliefs by observing behavior in context: they consider the country's pension reform record and the economic circumstances it faced. As explicated above, any European pension market would inflict more adjustment costs on Bismarckian states, because the liberal bias of European pension policies tends to fit better with Beveridgean nations. Yet there is variation across Bismarckian nations in their ability to adjust to EU mandated change. Differences in institutional structures, such as the size of the service sector (Iversen and Wren 1998), the extent of public sector employment (Martin and Thelen 2007), state capacity to "impose" unpopular reform packages on social partners (Hassel and Ebbinghaus 2000; van Wijnbergen 2002), as well as historical trajectories of social spending on certain age groups (Lynch 2006) all influence the precise costs of reform and illustrate the heterogeneity of Bismarckian nations. Thus, our theory of reputation entails two types of Bismarckian member states: "high cost" and "low cost" reform types. Although adjustment to EU regulations are less painful for low cost types, they will always try to mimic the high cost types – by exploiting the domestic constraints logic – in order to get a more favorable agreement at the EU level. Because both types are not distinguishable when they pool their behavior, the Commission forms beliefs about whether it is dealing with a "true" high cost type or with a bluffing low cost state.

Pension reforms provide clues about types that are difficult to gauge directly. Because any pension reform involving benefit reductions tends to be politically dangerous, reformers tend to get more accommodation at EU-level negotiations. This is because domestic constraints arguments articulated by reformers are interpreted as stemming from the high cost type and are therefore deemed credible. Countries that do not have a track record of painful pension reforms, by contrast, are branded as "bluffers" who are exploiting the domes-

tic constraints logic to get a better deal. The nature of national reform activity – pension benefit reduction or expansion – provides the EU Commission with the necessary information to discern the member states’ type.

## 6 Why political deliberations were not informative in 1991

The first attempt to create a single pension market was made in 1985, when it became clear that pension funds had been forgotten in Jacques Delors’ White Paper on the single market. Yet it was not until 1990 that the EU Commission began to take action in this field, when Director-General Leon Brittan outlined the three freedoms which were critical to the pension fund industry: freedom of investment, freedom of management, and cross-border membership (EFRP 2001).

However, neither Bismarckian nor Beveridgean systems were willing to reform their own welfare-finance arrangements in order to promote integration, and instead urged the other side to adjust. Uncertainty about member states’ true domestic constraints, and the concomitant inability to distinguish cheap talk from credible signals, resulted in bargaining breakdown. The most contested issues – investment regulations, biometric risk coverage, and taxation – were deemed “non-negotiable”, and member states were stuck in positions of principled opposition to the single pension market. Because the changes proposed by the EU Commission would have been more costly for Bismarckian nations and therefore politically dangerous, these states offered to create a single pension market that corresponded more closely to their own national institutional frameworks.<sup>3</sup> Yet, despite ostensibly legitimate concerns over the impact of the directive on domestic employers, this counteroffer was quickly dismissed by the liberal member states. The reason is that the counteroffer was not interpreted as a *costly* signal and therefore eroded the credibility of the domestic constraints argument.

Given that population aging and concomitant reform pressures weighed more heavily on PAYG pension systems than on mature pension fund cultures, the liberal states adopted a wait and see attitude, refusing to make any concessions to their conservative counterparts. As the Irish Association of Pension Funds remarked at the time, “The Irish, British and Dutch pension systems are far more developed than those existing in other EU countries and it is imperative that they be protected. It is better to have no directive than a bad directive.”<sup>4</sup> Some member states, notably Germany, even tried to turn the draft proposal on its

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<sup>3</sup>This counteroffer included the maintenance of quantitative investment restrictions, compulsory biometric risk coverage, and the limitation of the directive to off-balance sheet pensions.

<sup>4</sup>The Financial Times, April 15, 2002.

head. Although the Commission's goal was to liberalize freedom of capital across borders, the Bismarckian states attempted to use the directive proposal to enshrine tough investment regulations, which ultimately made it unattractive to the countries that had sought its adoption, in particular Britain, the Netherlands, and Ireland (Interview with Commission administrator, 23 June 2006). As a result of this deadlock, the Commission withdrew its proposal.

The following section analyzes the economic circumstances that made credible signaling at the EU-level possible, inducing member states to stop pooling their responses and instead reveal their true economic constraints. Economic change, national pension reforms, and efficient agenda setting by the Commission paved the way for the adoption of the 2003 pension directive.

## 7 Economic context

Our next task is to clarify why the EU Commission believed that re-opening negotiations a decade after the failed first attempt might be fruitful. What was different in 2003? Why did the first attempt to create a single pension market in 1991 fail? Pension scholars typically locate the cause for national pension reforms in the demographics of aging. But because unfavorable demographic trends have beset European societies for decades, the timing of recent pension reforms suggests that other forces, in addition to aging, must have been at work. The theory advanced here makes predictions about the effect of contextual variables. Agenda-setting reflects both the Commission's evaluation of member states' behavior and economic environment. In the decade after the first directive proposal was withdrawn, structural change began to shift governments' marginal utility for accumulating unfunded social security pension liabilities, particularly in Bismarckian nations. These developments tipped member states' preferences in favor of the single pension market.

Economic change was essentially precipitated by the transformation of labor markets from a society based on traditional industry and agriculture to a service-based economy (Iversen and Wren 1998). This shift changed the relative demand for skilled and unskilled labor. While traditional employment patterns had fueled expectations for a lifelong, uninterrupted job tenure, career structures in the service sector tend to be intermittent. This implies that individuals have less opportunity to acquire both social security and occupational pensions rights. Such an enormous occupational transformation is particularly problematic for

younger generations, who are aware that social security pensions will not suffice to maintain the standard of living during the retirement phase, yet have limited opportunities to build up employer sponsored pension rights because discontinuous employment arrangements, together with restrictive pension acquisition rules, such as long waiting and vesting periods, prevent them from doing so.

Iversen and Cusack have pointed out that the magnitude of the employment dislocations depend on the transferability of employees' skills: "When skills and benefits do not travel well, while large numbers of people face the risks of having to make such travels, one would expect demands for state-sponsored compensation and risk sharing to be high". (Iversen and Cusack 2000, p. 326). Compensation for the lack of skill transferability usually came in the form of early retirement or disability benefits to make labor market exit for older employees less painful and – equally importantly – to sugarcoat unemployment figures. Yet active labor market instruments were discredited, and often subject to budget cuts, when it became clear that employers exploited the early retirement option excessively for staff reductions, leading to a dramatic increase of beneficiaries entitled to unemployment assistance at a time when the pool of contributors continued to shrink (Rosenow and Naschold 1994; Martin and Thelen 2007).

Experiences with such costly and ineffectual state sponsored assistance is one of the reasons why Bismarckian governments were less opposed to European harmonization efforts in the area of pensions. This is because domestic reforms required to create a single pension market could be sold as a form of compensation to the young and middle aged generation, who tend to be primarily targeted for cutbacks in social security pensions. As pension scholars never tire to point out, the trickiest question associated with reforming PAYG pension systems is how to avoid punishing one generation by requiring them to finance their parents' pensions while at the same time saving for their own (Myles and Pierson 2001). The single pension market could thus be sold as a form of compensation: reduced PAYG pensions would be offset by better access to, and improved management of, occupational pension rights that are portable across borders. Given that more than 60 percent of young Europeans consider the possibility of being able to work anywhere in the European Union as an important right (Eurobarometer 1997, p. 113), the prospect of owning occupational pension rights even in case of career moves abroad represents no small enticement. As a result, a variety of recent legislative initiatives have aimed at expanding employer sponsored pensions. The next section takes a closer look at the nature of reforms that were carried out in the member states.

## 8 Recent pension reforms: credible signals during hard times

Even though Bismarckian pension systems have nowhere been radically transformed, several steps have been implemented in order to reduce the costliness of social security pensions and build up the underdeveloped second pillar. A few countries have moved towards a greater reliance on occupational pensions by introducing funded components to the first pillar. Others have raised the official retirement age, lowered benefits, or reversed the previous trend towards early retirement. These changes (described below), even though incremental, represented costly and therefore credible signals about member states' true reform types, indicating that previous opposition to pension market integration may have moderated.

### 8.1 Moves toward funding

In 1998 Sweden has introduced funded components that were emulated throughout Scandinavia and continue to inspire reforms in other Bismarckian nations. Swedish pensions today are mainly based on so-called notional defined contributions and are linked to lifetime earnings. Most of the pension is financed through PAYG, but 2.5 percent of income will go towards a funded pension administered by the state, with individuals able to choose their own fund. The level of pensions is based partly on the total contributions paid during working life and partly on the average life expectancy at the time of retirement. It is then linked to national economic growth. Because the scheme is based on actual contributions, it is reasonably stable and although it is not immune to demographic changes, the effect of a rising proportion of pensioners is partly offset by linking pensions to life expectancy. It creates a “partnership” between PAYG and funded schemes, although the funded element is small (Taverne 2001, p. 12).

Germany is another example that has introduced capital funded occupational pension plans. The so-called “*Riesterrente*” was introduced by the social democratic government in 2001. Whereas firms have traditionally provided occupational pension coverage *voluntarily*, employees are now *entitled* to an occupational pension by their employer, albeit only in the form of wage conversions into future pension claims (Schoden 2003, p. 26). This means that employers are now required to set up externally funded pension plans at the request of workers. To support uptake of so-called “Riester-pensions” the government generously subsidized the conversion of up to 4 percent of net wages into future supplementary pension coverage.<sup>5</sup>

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<sup>5</sup>Those subsidies are scheduled to run out in 2008.

## 8.2 Measures to raise the retirement age

Several countries have not only raised the official retirement age but have taken steps to reverse the previous trend towards early retirement. In 1992, the German government mandated a phased increase of the retirement age to 65 years with actuarial reductions in the case of early retirement (Schludi 2005, p. 132). Moreover, the retirement age of women was increased.

Italy, which had a very complex system with different official retirement ages under different schemes, has raised the retirement age in the main state scheme from 55 to 60 for women and from 60 to 65 for men. Italy is also phasing out the very expensive seniority pension, the *pensioni d'anzienita*, which allowed people to qualify for a full pension after 35 years of work. "Italy's problem is not the need for fundamental reform, because the basic issues have been tackled, but the need to speed up the time table for reforms already in place." (Taverne 2001, p. 13).

After a spurt of reforms in the early 1990s, France has made only little recent progress in reforming its pension system. There were drastic reforms of the basic pension and of the mandatory (PAYG) private sector occupational pension schemes in 1993. But attempts to reform the generous and expensive schemes for public servants and employees of public companies have been postponed. France has some of the lowest legal retirement ages in Europe, with an average of 50.3 to 59.9 for public employees and 61.2 in the private sector.

## 8.3 Steps to reduce benefits

A variety of actions have been taken in different countries to lower benefits, either by linking them to prices rather than earnings (Germany and Italy), or by changing the basis on which pensions were calculated (France and Italy). The effect has been a lowering of replacement rates. In Germany, the Kohl government introduced a demographic factor into the pension formula that would lead to a reduction of the standard pension level from 70 percent to 64 percent, but his social democratic predecessor, in keeping with his campaign promise, initially suspended it. The demographic factor was later reintroduced by the Schröder government, with a target of 67 percent. However, the pension level is widely expected to decline further in time (Schludi 2005).

## 8.4 Spread of the equity culture

Another factor alleviating resistance to pension funding may be the extent to which equity culture is gaining ground within the European Union. An obvious example is the growth of mutual funds. This trend may have a decisive influence on private pensions in the longer term. If people are happy to invest their savings in equities, why should they object to equity-based pensions? Some scholars found that the public favors private pensions. While the French government has often denounced the Anglo-Saxon approach to pensions, Taverne found that 78 percent of the population favored private pension funds for employees, with only 18 percent opposed (Taverne 2001, p. 14).

Furthermore, privatization proceeds rapidly in the EU. Companies are increasingly looking to the markets for finance. Hostile takeovers, which were once taboo on the continent, are becoming more frequent.<sup>6</sup> There is an increasing concern with shareholder value and responsibilities to shareholders. While this does not mean that the coordinated model of capitalism on the continent is being suddenly abandoned, these are all signs that the equity culture has become an important influence.

## 9 Agenda-setting by the EU Commission

The previous section detailed the range of pension reforms that were carried out in the late 1990s and 2000s. These reforms contributed to the member states' reputation and signaled to the Commission that principled opposition to pension market integration may have attenuated. Compared to PAYG social security pensions, occupational pensions played only a minor role for a small number of people in 1991. By 2003, however, several steps towards expanding the second pillar had been taken. The growth of nontraditional employment patterns with concomitant deprivation of pension rights provided an additional opportunity for the EU Commission to seize the issue area and invite member states back to the bargaining table.

However, this does not mean that agreement on a European pension directive was a foregone conclusion. Although economic change altered the costliness of creating a single pension market, both Bismarckian and Beveridgean endeavored to design the pension directive in accordance with their own national social and financial regulations. Because politicians tend to avoid far-reaching regulatory change in the area of pen-

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<sup>6</sup>a prominent example is the takeover of Mannesmann by Vodafone.

sions, neither side was keen on making concessions at the EU level just to return home with an agreement. In many ways, no deal on pension market integration was still the favored outcome for reelection-minded incumbents.

There is no consensus in the literature on the precise role of the EU Commission in influencing pension policies. Some scholars consider the agenda-setting powers of the EU Commission in this area as seriously limited because of its lack of financial resources and member state autonomy with regard to taxes and social security. (Haverland 2005, p. 2). While Haverland correctly points to the inability of the Commission to mandate redistributive regulations with regard to pensions, we argue that the Commission's agenda setting power is not confined to control over financial means. Other scholars recognize the role of the EU Commission as an agenda-setter by pointing to discussion fora and three policy networks that stimulate debate at the EU level (Pochet 2003). However, Pochet pays insufficient attention to the effectiveness of these networks in promoting a single pension market and does not analyze the Commission's strategic interaction with other potentially important players, such as the European Parliament or Council.

We also take issue with the claim that the more complex the discussions at the European level are, the more weight they carry, and the more options they offer for dealing with the challenges of aging (Pochet 2003, p. 7). First, a top spot on the agenda neither guarantees legislative passage nor the implementation of EU laws according to original intent. Secondly, complexity may stifle efficient decision-making, leading either to ineffectual directives or perpetual impasse. It is true that the creation of a single European pension market requires answers to many diverse questions, such as: should the social laws of the sending or the receiving country apply? What kind of pension institutions should be subject to European supervisory control? Should pension contributions, investment return, or the disbursed benefits be taxed? However, we argue that agreement at the European level is more likely when the agenda-setter is capable of *reducing* complexity. The subsequent part analyzes the specific manipulation tools the EU Commission used to accomplish this task.



## 10 Limiting the agenda: separating taxation issues from pension market integration

One method the EU Commission used to exercise agenda control included the elimination of particularly controversial issues from negotiations altogether. The subject matter that turned out to be most divisive during the 1991 deliberations was the question of how to tax occupational retirement income. The failure to develop a unified tax system in the European Union has long been a bone of contention between EU governments and multinational businesses. Each national tax authority allows some form of privilege to funded pension arrangements, which makes them attractive for employers and employees. However, the tax authorities are eager to make sure that any taxation of pensions fills their own coffers rather than those of another member state. Some countries, notably Britain and Ireland, insist that national parliaments, and not supranational institutions, should control taxation. Smaller states are opposed to tax harmonization because tax competition offers opportunities for national development (Genschel 2005, p. 65).

The main reason why efforts to unify the variety of taxation systems in the European Union into an EET system was met with more political opposition than other issues, such as the harmonization of investment regulations or social laws, is that the creation of common tax policies represents a classic time-inconsistency problem: why incur costs in the present when the benefits will not materialize until the far-away future, thus benefiting the political successor? The strong reservations politicians in many European countries harbor about exempting private or occupational pension savings from taxes and social security contributions stem from the fear of major short-term revenue shortfalls, affecting social budgets in particular. Country-specific trajectories of taxation regulations cannot be changed over night from a national to a European dimension, because political choices entailing high upfront costs and long maturation of benefits tend to be politically toxic.

These considerations lay at the heart of Germany's and Luxembourg's vocal opposition to tax harmonization. Because the ETT system is a variation of the EET system, resistance to the reorganization of the tax system was not as severe in Denmark, Italy, and Sweden (Van den Burg 2001, p. 11). But even countries that operate on an EET basis expressed doubts about tax harmonization. The most common fear was that some member states could, in effect, end up subsidizing others if they changed their tax laws. As the head of pensions at Smith and Williamson, a UK-based consultancy, remarked: "Gordon Brown is never going to

agree to parity with, for example, Italy, where state benefits are much more generous than ours.”<sup>7</sup>.

In light of the strong resistance in the member states the EU Commission came to realize that tax harmonization is a political, rather than a technical or legal matter that militates in favor of a more gradual, national reform approach. Thus, the Commission decided to divorce the broader goal of tax harmonization from the deliberations on the single pension market, designating it as a separate issue area. EU administrators involved in the failed 1991 negotiations who were interviewed for this project singled out tax harmonization as the main obstacle for moving ahead with pension market integration. Regarding issues of tax harmonization, one Commission administrator mentioned “In 1991, the member states simply had too much on their plate. Taxation of pension funds turned out to be the biggest obstacle for the creation of a common pension market.” (Interview with Commission administrator, June 21, 2006). Another administrator added: “Tax issues should have been excluded from the beginning, but we did not know that in the early 1990s. In 2003, we knew better.” (Interview with Commission administrator, June 20, 2006).

More than four decades ago, Schattschneider remarked that “all forms of political organization have a bias in favor of the exploitation of some kinds of conflict and the suppression of others because organization is the mobilization of bias.” (Schattschneider 1960, p. 71). The above discussion demonstrated that, after heavy contestation at the EU-level in the early 1990s, the issue of taxation of European pension funds was subsequently “organized out”. This is because the EU Commission eventually realizes that the intertemporal nature of the problem militated in favor of a more gradual approach at the domestic level. The next section explores the issues that found their way onto the Commission’s agenda and that were subsequently “organized in”.

## **11 Reducing uncertainty and building coalitions with key member states**

Another agenda-setting tool the EU Commission used efficiently in 2003 was reducing member states uncertainty about each others’ reform types by holding long educational sessions in the EU Council. The main supporters of pension market integration were Beveridgean pension fund cultures, including Great Britain,

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<sup>7</sup>Financial Times, August 19, 2002

Ireland, the Netherlands, Sweden, and Denmark. The pension industry in those countries saw great potential for growth in the creation of a single pension market, enabling them to get a foothold in countries where pension funds were poorly developed. The maturity of the second pillar pension sector in Beveridgean countries and abundance of skills in asset-liability management constituted a comparative advantage for the pension industry vis-a-vis foreign competition.

The most powerful opponents included nations with Bismarckian pension systems, most notably Germany and France, but also Luxembourg, Belgium, and the Southern European states. These countries had vociferously opposed the Commission's 1991 directive proposal that recommended the liberalization of investment regulations for pension funds, relaxation of regulations governing the provision of biometric risks coverage, and tax harmonization, among other things. The main reasons for the resistance is the underdeveloped second pillar pension sector in those countries, as well as the magnitude of welfare-finance reforms required for creating a single pension market.

The critical contribution of the Commission was to consult extensively not only with member state representatives, but also with European union and business representatives, as well as the European Federation for Retirement Provision. As a result of the Commission's decision to hold multiple sessions on pension market integration in the Council, the member states learned two things: first, a better understanding of member states' peculiar pension systems helped them realize what kind of policy change would so embarrass their peers as to be unproductive. Secondly, they revealed what kind of changes might be politically feasible, despite the existence of domestic veto points.

In 1991, no country wanted to implement welfare-finance reforms in order to achieve pension market integration. However, changes in the economic environment, including structural change from an industry-based to a service economy as well as the expansion of second pillar pensions, altered governments' utility of creating a single pension market. In this environment, governments had an incentive to depart from their principled opposition to pension market integration and instead explore room for maneuver.

The Commission's strategy of consulting widely and educating Council members about the peculiarities of Bismarckian and Beveridgean pension systems contrasts starkly with the approach taken a decade earlier. In 1991, the directive proposal was hurriedly drawn up and neither member state representatives, nor social

partners or lobby groups, such as the EFRP, were extensively consulted. More importantly, the economic environment in which deliberations took place was not conducive to credible deliberations. The dislocations wrought by the contraction of the traditional employment sectors (agriculture and industry) were not as painful as a decade later. More importantly, domestic PAYG pension cutbacks and measures taken to expand employer sponsored pension coverage between 1992-2002 surpass the few minor reform initiatives undertaken in the 1980s.

Strikingly, the criticism member states voiced regarding pension market integration differed considerably in 1991 and 2003. Whereas in 1991 Bismarckian member states saw no common ground for compromise, they were more open to an agreement in 2003, voicing only their strongest reservations against certain stipulations in the directive. In 2003, member states and Commission agreed on a compromise regarding the previously contested issues of investment rules and biometric risk coverage. Concerning investment rules, the directive mandates that pension assets be invested according to the prudent man rule, signifying the liberalization of investment regulations in Bismarckian nations. Regarding biometric risk coverage, the member states agreed on mutual recognition, allowing Bismarckian states to set higher standards than their Beveridgean counterparts.

Following this compromise, the pool of non-negotiable issues had shrunk considerably. What was eventually excluded from the scope of the IORP directive comprised only a few policy areas that were highly specific to certain pension systems and that the respective countries cared very intensely about. The most important players in this game were the main opponents of change (Germany and France), the main supporter (Great Britain), as well as the presidencies of the European Union between 2002 and 2003 (Spain and Italy). Let's consider the crucial objections each harbored – and that were eventually accommodated – in turn.

## 11.1 Germany

Germany's main hesitation to support pension market integration originates from the pervasiveness of on-balance sheet book reserve pensions. With 60 percent of all occupational pensions being book reserve pensions, it constitutes the most popular form of employer sponsored pension in Germany. Firms prefer book reserve pensions to externally funded pension institutions because it provides them with a cheap source of finance as well as an effective staff retention device. The creation of a single European pension market posed

a threat to this cheap capital as well as to the long-term nature of German labor relations. This is because “security concerns” by the EU Commission as well as other member states militated in favor of funding such pensions. Yet, a broad societal coalition consisting of employers, unions, and the government fought hard, and successfully, for the exemption of book reserve from the scope of the directive. Thus, article 2 (2e) in the 2003 directive text specifies that the directive shall not apply to “companies using book reserve schemes with a view to paying out retirement benefits to their employees.”

In return for exempting book reserve pensions from the directive, Germany decided to drop other reservations it previously regarded as non-negotiable, including resistance to the liberalization of investment regulations for pension funds, as well as its insistence on making the provision of biometric risk coverage mandatory for the European pension industry. The Commission’s acceptance that book reserve pension schemes should be excluded from the directive induced Germany to make concessions in those issue areas. The persuasion of one of the most powerful critics of the original directive sent a strong signal to other reluctant member states. As one Commission administrator recalls: “We finally understood that Germany’s biggest concern were the book reserve pensions. As soon as we got the Germans on board, it was much easier to persuade other hesitant member states.” (Interview with EU Commission administrators, June 20-23, 2006).

## 11.2 France

France was able to negotiate its way out of the pension fund directive relatively easily, declaring that France simply does not have pension funds or schemes in the sense that they exist elsewhere in Europe. The second pillar in France is essentially provided by ARRCO, for blue-collar workers and AGIRC for white-collar employees. Both deal with agreements internally and are highly regulated. The schemes are all jointly run by unions and employers. Only a minority of employers makes pension promises beyond statutory requirements. Of these, the majority take the form of book reserves, as in Germany. Consequently, France shared many of Germany’s doubts. A well-established EU regulation that exists since the 1970s was the solution in this case (Council Regulation (EEC) No. 1408/71 of 14 June 1971). This regulation lays down certain rules for the management of pension schemes of employed persons, self-employed persons and members of their families moving within the European Union. However, it explicitly excludes from its scope social security schemes. Thus, by declaring that all occupational pension schemes fall under the 1408/71 regulation, France

managed to exclude all French pension schemes from the scope of the 2003 directive. However, the directive also specifies that no country must discriminate against foreign pension funds, indicating that France does not escape the specter of foreign competition.

### **11.3 Great Britain**

Because the City of London had a clear competitive advantage in the business of pension management vis-a-vis financial centers in Bismarckian pension cultures, Britain stood to gain most from the liberalization of investment regulations (Talani 2000). The occupational pension sector is mature, the pension fund industry competitive, and asset-liability skills abundant. The prudent man rule is already used to invest pension assets, thus relieving the country of any adjustment costs in this area. However, accommodating demands by the powerful British pension funds, Britain successfully opposed German and French attempts to force the European pension industry to offer biometric risk coverage. Britain was initially opposed to exempting book reserve pensions from the scope of the directive, arguing that lack of oversight by EU institutions would give employers sponsoring such pensions an unfair advantage. However, given that the Bismarckian nations eventually accepted a liberalization of investment regulations, as well as the principle of mutual recognition regarding biometric risk coverage, Britain conceded. The Bismarckian states, on the other hand, reluctantly agreed to article 16 (2), which specifies that member states may allow pension funds for a limited period of time to have “insufficient assets to cover technical provisions”. This stipulation clearly reflects the position of the British pension funds, trumping the security concerns of the Bismarckian insurance industry.

### **11.4 The Spanish and Italian presidencies**

Each member state, on taking up the presidency, has tended to give emphasis to directives that most closely affect its own nationals. In 1993, a newspaper article warned that “if agreement on the [IORP] directive is not reached by the end of the Belgian presidency (31 December 1993), the next five presidencies (Greece, Germany, France, Spain and Italy) are unlikely to give this particular piece of EU legislation any priority, because these countries do not at present have large and active private pensions industries.” (European Savings Markets, October 21, 1993). Given the underdeveloped second pillar pension sector in all of these countries, neither the Spanish nor the Italian presidency was expected to push the issue of pension market integration. And yet, the impasse in the Council was broken under the Spanish presidency in 2002, while

the directive itself was signed into law under the Italian presidency in 2003.

Why would two member states contribute to progress on a policy issue that does not rank high on the priority list of their own nationals? In the end, it came down to two issues: the prestige associated with shepherding a directive through the legislative process, and the exclusion of the issue that was most important to the respective country. For Spain and Italy, it was most important that the pension fund directive also applied to pension institutions that do not have legal personality. This is because in Italy and Spain, pension funds are of the contractual form. In this case, pension funds do not have legal personality or capacity, but the plan members have a legal title to the pension fund assets. The pension fund assets are held in an account managed by a financial company for plan affiliates, where the account is legally separated from the balance sheet of the managing entity (OECD 2001, p. 5). In the end, these concerns were accommodated by Article 2 (1) of the 2003 directive text by specifically including pension institutions without legal personality.

The nature of the compromise the European member states reached in 2003 reveals that the Beveridgean states sacrificed more than their Bismarckian counterparts, whereas the latter made concessions in areas they cared only marginally about. This outcome supports our hypothesis that the 2003 directive is the result of reduced uncertainty about member states' domestic constraints, due to effective agenda setting by the Commission. Although this directive constitutes a first step towards a single pension market, it is unlikely that there will be an upsurge in cross-border pension portability anytime soon. It remains to be seen whether individual member states will interpret the directive in ways that will increase or inhibit cross-border pension transfers. Furthermore, sensitive issue areas such as taxation of transferred pension claims have yet to be sorted out before we can speak of a truly integrated pension market.

## 12 Conclusion

This paper analyzed the European dimension of pension policies. We argued that competition issues, structural change, and domestic pension reforms opened a window of opportunity for the EU Commission to invite deliberations on pension market integration. The disruption of traditional employment patterns and concomitant loss of pension rights generated demands for improved access to, and efficient management of, occupational pensions. Furthermore, recent initiatives in Bismarckian nations to cut back social security pen-

sions and expand the second pillar increased the salience of pension market integration at the European level.

While economic change afforded demands for pension market integration more attention, it was effective agenda control by the European Commission that is causally linked to adoption and design of the 2003 pension fund directive. By excluding issues of taxation from the purview of the directive, reducing uncertainty about member states' true domestic constraints, and building coalitions with key member states, the Commission helped foster a consensus between Bismarckian and Beveridgean states. This contrasts strongly with the first attempt to create a pension fund directive in 1991, when member states had no incentives to reveal their true domestic constraints and the Commission made no attempt to reduce member states' uncertainty about each others' types. Even though the 2003 pension fund directive has been correctly criticized as an incomplete legislative patchwork, the fact that fifteen member states were able to agree on some welfare-finance harmonization makes it a bargaining success.



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