Reforming Public Pensions[1]

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Introduction

The postwar expansion of old age security systems in the developed capitalist democracies was more or less complete by the mid-1970s. Almost from the moment of maturation, however, discussions began over the looming "pension crisis." The intensity, timing, and rhetoric of these discussions varied significantly from country to country. By the mid-eighties, however, the first serious efforts to reform national pension systems and resolve the "crisis" were underway. Cross-nationally, the reform movement gained momentum in the late 1980s and accelerated further in the 1990s. It is still underway today with no end in sight. By 1997, almost all of the OECD countries had gone through at least one major effort to redesign their old age security systems. Old age pensions, long one of the most stable features of the post-war social contract, has become a sector marked by dramatic policy change.

The big question lurking behind any discussion of these "reforms" concerns the long term future of the "welfare states for the elderly" created in the postwar decades. Is the welfare state withering away or merely being redesigned? Does redesign mean convergence on some hypothetical neo-liberal model of the welfare state as advocated for example by the World Bank (1994) and numerous conservative think tanks, one in which collective provision for income security in old age will be replaced by a privatized, market-based, model of retirement savings with the state retaining only the residual responsibility of meeting the income needs of the most impoverished? Will all these changes result in a return to the not so distant past when large numbers of the elderly found themselves in a state of relatively abject poverty?

Without claiming to have anything like a definitive answer to these "big questions," our conclusion about the future of the welfare state for the elderly in the OECD nations can be summarized as follows. With few exceptions, the size of the welfare state for the elderly in the next century will be much larger than it is now. This is simply because demand for benefits will rise more quickly than the capacity of policy-makers to cut entitlements. Reform can slow down the rate of spending growth but with rare exceptions will not reverse it. Nor will nations converge, either around a common level of spending or in the design of their old age pension systems for two reasons. First, the options available to policy-makers, whatever their politics, are constrained by institutional and programmatic designs inherited from the past. Welfare states, and pension systems especially, are a *locus classicus* of path dependent change (Pierson 1994). Path dependency does not mean change is not occurring; rather, the set of possible changes is constrained by past histories of pension development. Given quite different systems of existing commitments and popular expectations, reformers in different countries are choosing reform options from quite different “menus.” The second reason for continued diversity in the “new” welfare states is the same as that which created diversity in “old” welfare states. Cross-national differences in the organization and political capacities of the key constituencies affected by welfare states — workers, employers, women, private insurers and public officials — continue to have an important impact on the character of reform, just as they have in the past.

In section one, we argue that the problem driving pension reform is not only or even primarily the rising demand for pensions but rather growing difficulties with the method of financing and distributing benefits by which most countries meet this demand: pay-as-you-go defined benefit plans financed from payroll taxes. Payroll taxes constitute an increasingly problematic base for pension finance. In section two, we build on this analysis by showing how the character of existing finance and benefit systems structures reform. Our principal claim is that the key variable shaping broad reform outcomes is the scope, maturity and design of these paygo pension schemes. Depending on this variable, reform has proceeded on one of two distinct tracks.

Our first group of countries are the “latecomers” -- those cases where significant pay-as-you-go, earnings-related programs were not in place at the end of the golden age. Strikingly, among the latecomers, the dominant reform path has been an *expansion* of retirement provision. In these countries, the last two decades have seen efforts to create viable systems of old age security, albeit of a very different sort from that provided by earlier models. Interestingly, the traditional explanation for welfare state growth -- the power resources of organized labor and the political left -- has remained salient for this set of countries. Reforms were more likely and have taken a more “collective” form in those cases where organized labor exerts greater influence -- industry-based and generally with a strong organizational role for labor unions. Yet in the new environment of the 1980s and 1990s the form of expansion has been quite different from that of pension systems that matured earlier -- funded and based on regulation rather than pay-as-you go and based on public spending.

Most of the affluent democracies fall into a second group. Where earnings related, pay-as-you-go programs were highly developed and mature by the mid-1970s, the path of reform has been one of adaptation to austerity. Because of politically prohibitive transitional costs, radical shifts towards funding are largely precluded as a reform option. And in view of the harmony of interest among key actors (labor, business and government) to restrain and stabilize the growth of payroll taxes, reform has meant retrenchment, albeit of a particular sort. The political problem in the mature systems has been how to scale back current and, especially, future benefits in old age pension systems given the powerful constituencies and strong sense of moral entitlement connected to such programs.

In the mature cases, the largest reforms involve the reduction and rationalization (greater targeting) of interpersonal transfers so that future benefits will more closely reflect past contributions. Where pension systems currently result in a large volume of interpersonal transfers (horizontal or vertical) among beneficiaries the division between "earned" benefits and interpersonal transfers is made more transparent so that financial responsibility for redistributive transfers can be shifted from payroll taxes to general revenue. Pension systems that provide an opportunity to reduce expenditures by means of "rationalizing" redistribution provide policy-makers with the opportunity to adopt retrenchment reforms that are potentially self-legitimating. In contrast, where the volume of interpersonal transfers is low (where benefits have been closely linked to contributions), such a reform strategy is unavailable and change will be more difficult since retrenchment requires universal -- "across-the-board" — reductions in entitlements.

In most of the "mature" cases, the need to avoid blame and legitimate reform creates incentives for consensual, negotiated reform strategies. In most of the countries where significant reform has occurred, cooperation among the major parties and/or the "social partners" (business and labor) has been a critical precondition for successful implementation. As is discussed in other chapters in this volume, however, the capacities to pursue and enforce such negotiated reforms vary considerably cross-nationally.

Our analysis contrasts sharply to both that of convergence analysts, who anticipate a move towards "one best practice" but ignore the radically different starting points of different countries, and to naive versions of institutionalism that stress inertia and the uniqueness of each case. The pension crisis is being addressed, we argue, through processes of *path dependent change*. In opposition to a naive institutionalism, we emphasize the big shifts that are taking place in systems of retirement provision, on the one hand, and, on the other, the clear cross-national patterns which make it possible to identify clusters of countries sharing a broadly similar reform dynamic. Against convergence theorists, we stress that there is no single "destination" and that the character of changes will be powerfully shaped by the constraints and opportunities presented in distinctively constituted pension systems.

I. The Nature of the Crisis

Explanations of the wave of pension reform currently sweeping the OECD countries typically invoke a familiar series of intertwined pressures (Weaver, in press) including demographic and budgetary pressures, concerns about competitiveness, and a resurgence of conservative ideology. Without disputing that all of these factors play a role, we think it is difficult to explain either the timing, extent or type of reform as simple linear extrapolations of these pressures.

Table 1: Aging, Work and Social Expenditures, 17 OECD Countries

	1	2	3	4	5	6	7
	Population 65+ 1990	Normal Ret. Age M/F 1992	Emp/Pop Men 55-64 1995	Pension Exp %GDP 1995	Proj. Pens. Exp %GDP 2040	Increase (5/4) 1995-2040	Significant Reform 1980-1997
Nordic Countries							
Sweden	17.8	65/65	64.4	11.8	14.9	1.26	Pending
Norway	16.3	67/67	70.0	5.2	11.8	2.27	Yes
Denmark	15.4	67/67	63.2	6.8	11.6	1.71	Yes
Finland	13.3	65/65	34.9	10.1	18.0	1.78	Yes
Mean	15.7	66/66	58.1	8.5	14.1	1.66	
Continental Europe							
Germany	14.9	65/65*	47.2	11.1	18.4	1.66	Yes
Austria	15.1	65/60	40.8	8.8	14.9	1.69	Yes
Belgium	15.0	65/60	34.5	10.4	15.0	1.44	Yes
Netherlands	13.2	65/65	39.9	6.0	12.1	2.02	No
France	13.8	60/60	38.4	10.6	14.3	1.35	Yes
Italy	14.8	60/55*	42.3	13.3	21.4	1.61	Yes
Mean	14.5	63/61	40.5	10.0	16.0	1.60	
Anglo-Saxon							
Canada	11.3	65/65	54.0	5.2	9.1	1.75	Yes
Ireland	11.4	66/66	59.1	4.1	2.9	0.71	No
UK	15.7	65/60	56.1	4.5	5.0	1.11	Yes
USA	12.6	65/65	63.6	4.1	7.1	1.73	Yes
Australia	10.7	65/60	55.2	2.6	4.3	1.65	Yes
NZ	11.1	61/61	63.0	5.9	9.4	1.59	Yes
Mean	12.1	65/63	58.5	4.4	6.3	1.43	

Sources: Population, Retirement Age, Pension Expenditures: Organization for Economic Cooperation and Development. 1997. *Ageing in OECD Countries*. Paris: OECD.

Employment/Population Ratio: Organization for Economic Cooperation and Development. 1997. *Employment Outlook*. Paris: OECD.

A striking feature of the politics of reform is that it seems unrelated either to current or projected levels of expenditure on old age benefits (Table 1, cols. 4 and 5). The countries of Continental Europe face the highest levels of spending both now and in the future, in part because of generous pension schemes but also because of their very high rates of early retirement and labor force withdrawal by those under 65 (Table 1 col. 3). Nevertheless, one hears virtually the same rhetoric of "crisis" whether one travels to high spending Italy or to low spending Australia. [2]

Population aging is often invoked as a major motor of reform. As a first approximation, however, one could say that it is not population aging that is the problem; rather, it is the design of the typical old age security system that *makes* population aging a problem. The problem can be stated as follows. The large pay-as-you-go defined benefit schemes that developed in Western Europe and North America in the postwar decades are financed by governments with a tax on only part of national income, namely labor market earnings. Unlike programs financed from general revenue, transfers financed exclusively from payroll taxes impose all of the cost of an aging society on wage income. Furthermore, since it is common to limit covered earnings to the bottom half or two-thirds of the earnings distribution, the cost falls disproportionately on low and moderate wage-earners and especially younger workers.[3]

Thus the pension dilemma facing policy-makers has both a (widely-recognized) demographic component and a (less well-recognized) wage component. The demographic component is the changing ratio of wage-earners to retirees which is declining, a result of declining fertility exacerbated by a secular decline in the retirement age and increased longevity. The wage component is slow growth in real wages, which most policy-makers assume will continue into the future.

The problem is usually framed by comparing implicit "rates of return" in a pay-as-you-go scheme to its major alternative, a fully capitalized scheme financed from returns on investments. The return in a funded model depends on long term rates of return to capital (real interest rates). The implicit "rate of return" in schemes financed from a payroll tax is the annual percentage growth in total real wages ("returns to labor"). Total real wage growth is a function of the growth in the average wage multiplied by the growth in the number of wage earners. The latter term is in turn a function of population growth and the rate of labor force participation. Quite simply, then, the financial soundness of old age pensions

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[2] When one of the authors pointed out to a senior official in Australia's Department of Social Security that even the most dire projection for Australia's old age security budget left the country spending only about 4.5% of GDP, less than a third of what Italy spends today, he was told: "That won't cut any ice here."

[3] In 1992, for example, approximately 40% of labor income was exempt from the payroll tax for the Canada/Quebec Pension Plans. Source: Social Policy Simulation Data Module, Statistics Canada.

financed from payroll taxes depends on high wage growth, high fertility, and high rates of labor force participation.

Given the values of these parameters in the 1960s -- rising wages and a growing workforce -- most "sensible" treasury officials would have advised their ministers to opt for a paygo design. Paygo offered considerable additional advantages. It preempted objections to state control over large capital pools, and side-stepped widespread public distrust of capitalized pension schemes in countries where depression and war had devastated pension funds in the first half of the century. Furthermore, paygo systems offered enormous "front-end" political benefits during the initial phase-in period. For the first generation of contributors, there was no preceding generation of entitled pensioners. Politicians could offer a potent combination of modest payroll taxes, generous promises of future pensions, and "unearned" benefits for those near retirement age. Only gradually would these systems mature, with a full cohort of pensioners who had made large contributions over their entire working lives. The expansion of paygo earnings-related pensions during the 1960s, and early 1970s was reinforced by growing wage pressure with current real wage increases traded off in exchange for promises of higher real pensions in the future. Pensions became a "deferred wage" that could be used to purchase labor peace as well as political popularity (Myles 1988).

By the 1990s everything had changed. Values produced by the Canadian Department of Finance illustrate the turnaround (see Table 2).[4] Clearly by the end of the eighties a "sensible" treasury official would be advising her minister that the model put in place in the sixties was in difficulty. Irrespective of whether projected expenditures represent five or twenty-five percent of GDP, the parameters that made the pay-as-you-go design the model of choice in the 1960s — rising wage rates, full employment, and comparatively high fertility — had changed dramatically. Real wages and the size of the labor force were now rising slowly if at all.

The threat of ever higher payroll taxes in the future generates several problems. In light of the slowdown in real wage growth, trade union officials as well as treasury officials face an inter-generational dilemma: How to reconcile the income needs of retired workers with the downward pressure on take-home pay of active workers while non-wage income is comparatively immunized from such pressures. At the same time, policymakers, employers, and unions have shared a growing concern about the employment effects of rising payroll taxes. As Scharpf, Esping-Anderson and others have argued, payroll taxes make the cost of labor increasingly inflexible, especially at the lower end of the labor market where the social safety net, minimum wages, or industrial relations systems often make it difficult in practice for employers to pass such costs on to employees (Esping-Anderson 1996; Scharpf 1997). Even if payroll taxes are not be the "killer of jobs"

[4] Similar figures for a broader range of countries can be found in Davis (1995:37)

Table 2: Real Growth in Total Wages and Salaries and Real Interest Rates, Canada, 1960s-1990s

	1960-69	1970-79	1980-89	1990-94
Real Growth in:				
Total wages and salaries	5.1	4.8	2.1	0.0
Real interest rates	2.4	3.6	6.3	4.6

Source: Canada. 1996. *An Information Paper for Consultations on the Canada Pension Plan*. Ottawa: Department of Finance

as often portrayed, rising unemployment levels typical of many economies in the 1990s created an unfavorable environment for calm acceptance of yet further increases.

The current wave of pension reform, then, is essentially a matter of adapting pension regimes designed for an "old" political economy to one compatible with a new policy environment. If paygo financing from payroll taxes is the problem what is the solution? On the financing side, the choices include shifting the balance of financing toward capital investments, general revenue or some mix of the two. Alternatively, benefits can be cut but this raises the thorny question of "for whom?" The choices are not endless but they are multiple. The analytical task is to account for which of the many possible strategies are actually selected in the reform process.

II. Pension Reform as a Path Dependent Process: Capitalizing Old Age Pensions

Recent work in the "new institutionalism" has drawn the attention of political scientists to the ways in which the "rules of the game" help to structure political conflicts (North 1990; Skocpol 1992). While this discussion has often focused on formal institutions, extensive policy arrangements also become fundamental institutional frameworks, creating rules, constraints, and incentives for future political action. Where government activity is widespread, "policy feedback" and "path dependency" are likely to be a major contributor to the dynamics of political reform (Skocpol 1992; Pierson 1993).

In the standard world of neo-classical economics nations are bound to converge on a single equilibrium as some choices prove their superiority over others (i.e. are more "efficient" than others). This is because the neo-classical model assumes a world of decreasing marginal returns which engender negative feedback leading to a (single) predictable equilibrium (Pierson 1997). Or more simply, if I choose a strategy that is inferior to the most efficient strategy, I will be "punished" for my choice (negative feedback) and will soon change my behavior or go out of business. Convergence is to be expected.

Many social processes *are* characterized by declining returns and negative feedback as the model assumes; other processes are not (Pierson, 1997). Instead, they are characterized by "increasing returns" and self-reinforcement; each step along a path produces consequences which make that path more attractive in the next round and raise the costs of shifting to an alternative path. Timing, place, and sequence — in short, *history* — matter a lot in processes of the latter sort but not in the former.

Economists have made considerable advance in the study of such path dependent processes in areas as diverse as the study of technological change (why did the PC win out over the Mac?), economic geography (why Silicon Valley?) and international trade. One of the factors Brian Arthur (1994) identifies as a major source of path dependency, namely large set-up or fixed costs, is particularly important: when set-up or fixed costs are high, individuals and organizations have strong incentive to identify and stick with a single option. Once a low-density suburban infrastructure has been built up around roads and the automobile, for example, the shift to an urban design based on mass transport becomes prohibitively expensive.

The evolution of extensive pay-as-you-go pension systems represent an excellent example of such a path dependent process. Once mature, any proposal to shift to from a paygo to a funded design, whether public or private, creates a huge "double-payment" problem. Because it is too late for retirees to create an alternative source of retirement income, current payroll taxes are "precommitted." Capitalization (or pre-funding) thus requires current workers to continue financing the previous generation's retirement while simultaneously saving for their own.[5] The "double-payment" problem, coming on top of already heavy pressures to lower benefits and increase taxes on the working population, is likely to present an insurmountable barrier to privatization or any other reform intended to transform a mature pay-as-you-go pension scheme into a funded one. [6]

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[5] The cost of financing existing obligations can of course be shifted to general revenue and financed out of current tax revenues or shifted into the future through debt financing (shifting the costs to future taxpayers). The 1997 Hungarian reform, for example, which introduced a partial privatization created a significant double funding problem. The formula chosen was to rely mainly on debt financing in the early years shifting the balance toward tax financing in the following decade (Palacios and Rocha 1997).

[6]There are additional elements of path dependence associated with these systems. Establishment of generous pay as you go systems will tend to crowd out private sector provision, and over time this

Illustrating the Double-Payment Problem: Britain and the United States

Thus our central hypothesis is that how far one has gone down the path of paygo provision is critical for delimiting reform options. We illustrate this point briefly here by contrasting the experiences of Britain and the United States over the past twenty years, and then pursue the same point more systematically in the next two sections, which examine the less mature and more mature systems in turn. We focus on Britain and the United States because each is a "liberal" welfare state where conservative politicians were interested in pension privatization. What differentiated the two cases was the degree to which pre-existing pension systems were institutionalized (Pierson 1994).

Because alternating Labour and Conservative governments had taken turns scrapping their predecessors' plans for two decades, the Thatcher government was lucky enough to inherit a relatively new paygo earnings-related pension system, SERPS. The legislation for enabling SERPS was passed in 1975 and the first contributions made in 1978. Thus in 1985, when the Conservatives began actively considering reforms, the new system had been in place for only seven years. The Tories were well aware that the immaturity of SERPS provided a brief window of opportunity for privatization. As then-junior-minister John Major noted in the House of Commons debate over pensions reform, "the way in which SERPS works means that every year of delay leaves people clocking up expensive rights which must be honored in the future" (House of Commons 1986, col. 105).

Even for a system that had been in place for less than a decade, pursuing a shift to a funded regime created big problems. The Thatcher government's initial gambit, to quickly shut down the immature earnings-related pension system (SERPS), was withdrawn following withering criticism from all directions. The opponents included not only the Labour Party and groups representing the elderly, but, revealingly, the highest reaches of the Treasury and powerful private sector allies of the government, including the major private insurance companies and the Confederation of British Industry. The latter groups were concerned that the double-payment problem would lead to higher payroll taxes, lower benefits, or both. Forced to retreat, the Thatcher government had to pursue a more gradual approach. The 1986 reforms incrementally but decisively shifted policy toward private pension alternatives to the state earnings-related scheme.[7] The government is currently pursuing policies which will further diminish the public plan and the majority of workers (68% in 1991) are now "contracted out" of SERPS.

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will weaken the potential sources of support for privatization (Teles 1998). Financial markets for individual investors are notoriously weak in many of the countries with extensive and long-standing "Bismarckian" pension systems.

[7]Essentially, the government offered tax subsidies for personal pensions, along with significant cuts in the public sector scheme that left individuals "free to choose" but made the decision to opt for private coverage attractive to almost anyone under the age of 40.

Britain was a latecomer. It had not traveled very far down the path of public sector earnings-related provision. Even so, the transition was very difficult even for a committed and powerful conservative government. Capitalization and, in this instance, privatization was possible because of the system's immaturity, and because the government agreed to shift a significant share of the "double-payment" problem "itself" (i.e. to general revenue) in order to limit the political outcry. Tax subsides for the expanded private pension system will offset much of the budgetary savings anticipated (Disney 1997).

In the United States, by contrast, the "double payment" problem was a much more formidable reality. When the Reagan administration arrived in 1981, Social Security had been in place for almost five decades. The window for full-scale privatization had long since closed. The financial resources needed to build a private-sector alternative were already committed, through payroll taxes, to the current generation of elderly. Those advocating steps equivalent to Britain's SERPS reform, like the CATO Institute's Peter Ferrara, remained politically marginal figures during the 1980s, and the reform of Social Security in 1983 quickly took the form of negotiated retrenchment, as we discuss further below.

By the 1990s, when social security reform again reached the agenda, a number of conjunctural factors had made privatization a more prominent political option. Republicans were in a far stronger position in Congress, and had moved well to the right on welfare state issues. The previous decade's expansion of IRAs and 401(k)s, the mutual fund explosion, and the historically unprecedented performance of the stock market had heightened the allure of individualized accounts. Finally, the movement of the government budget into surplus for the first time in twenty years opened the possibility that revenues might now be available to help fund a transition. Nonetheless, it must be emphasized that the size and scale of the existing paygo pension system put significant constraints on the scale and timing of any such transition. As a recent issue of *The Economist* (April 11-17, 1998:20) concludes, while privatization has moved from the margin to the mainstream, there is a long road ahead to persuade both ordinary Americans *and* the mutual fund industry (who fear greater regulation) that privatization is in their best interests.

While a wholesale shift from a paygo to a funded design is not impossible, examination of the conditions under which capitalization has emerged as the preeminent form of financing old provisions for the 21st century does not augur well for proponents of privatization in the United States.

Path I: Latecomers and the Development of Funded Provision

A number of OECD countries did not establish public, pay-go earnings related systems by the end of the post-war boom. Capitalization has become the distinctive characteristic of what might be called the "late followers" in the development of modern old age security systems. By 1980, four countries had yet to establish universal "second tier" paygo earnings-related schemes (Australia, Ireland, the Netherlands and New Zealand). Two others (Denmark, Switzerland) had very modest earnings-related schemes that did little to satisfy the income security needs of middle income workers. A seventh (Britain) had enacted a public scheme but had only just begun to implement it. By the early 1990s four of the seven countries (Australia, Denmark, the Netherlands, Switzerland) had created universal or quasi-universal capitalized pension schemes not as a replacement for, but as an addition to, their existing programs.[8] A fifth (Britain) had revoked its new paygo earnings-related public scheme (while leaving its basic flat rate pension in place), replacing it with a capitalized and largely private scheme.

Funded defined contribution plans were made mandatory in Switzerland in 1983 and in Australia in 1992. Dutch occupational pensions could be thought of as "quasi-mandated." While only 26 percent of Dutch workers are union members, state regulation of the labor market (extension laws) requires that all benefits negotiated at the bargaining table be extended to non-union workers while non-union firms inevitably follow the lead of the unionized sector to remain competitive. In 1980, 60 percent of Dutch workers were covered and by the 1990s this figure had risen to 90 percent. In Denmark, where the vast majority of employees are unionized, labor went on a pension offensive in the late eighties with the result that coverage rose from about 35% in 1986 to over 80% of the labor force by 1997 and government officials concluded that mandating was unnecessary.

More detailed summaries of these reforms can be found in Myles (forthcoming). For our purposes, the significant fact is that absent the constraint of a large paygo earnings related scheme, pension reform in the 80s and 90s was characterized by a dynamic of expansion rather than contraction. With the exception of Switzerland, all of these countries also represent alternative trajectories of what is often characterized as the "Beveridge" path to old age security, countries that began with means-tested schemes for the "elderly poor" rather than the "Bismarckian" earnings-related pensions for superannuated "workers." The typical pathway for the so-called Beveridge countries was a subsequent shift to universal flat benefit schemes with an additional tier of paygo earnings-related benefits coming only much later. Except for Switzerland, the "late followers" were Beveridge countries

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[8] Canada, a country with a very modest second-tier plan might, like Switzerland, was also a potential candidate for supplementing the existing system with mandatory occupational pensions at the beginning of the 1980s. During the Great Pension Debate that ran roughly from 1976 to 1984, such an option was put on the agenda as a way of supplementing was then seen to be an inadequate Canada Pension Plan (CPP). The reformers and especially organized labor rejected this option in favor of expanding the paygo CPP, a strategy that ended in failure. Following the poor performance of equity markets in the 1970s, however, it is hardly likely that the funded option would have been considered preferable to paygo even for purely financing reasons (see Table 2).

that did not make this last transition before 1980.[9] Moreover, Switzerland is an ambiguous exception to this pattern. As Bonoli (1997) writes: "In a way the Swiss basic scheme is a compromise between the Bismarckian tradition of earnings-related contributory pensions and the Beveridgean flat-rate approach" and goes on to note that Switzerland is often counted among the "flat-rate" countries in comparative research.

Table 3: Nations with Capitalized Earnings-Related Pension Schemes, 1998

	Defined Contribution	**Defined Benefit**
Fully Capitalized	Australia Denmark* Switzerland	Netherlands* United Kingdom
Partially Capitalized	Sweden (pending)	Canada

Notes: Does not include funds invested in government debt.

Classification of DB and DC identifies the predominant pattern.

*** = non-mandated but quasi-universal (see text)**

The political dynamic generating these changes were also broadly similar. The absence of a universal earnings-related scheme for all employees did not mean no one had such coverage. Civil servants, professionals and workers in unionized sectors were typically covered by employer plans that received large state subsidies through the tax system. In at least three of the four cases (we have been unable to uncover political analyses of the Swiss case) the pressure for reform came from organized labor to spread these entitlements across the whole of the labor marker. In Denmark and the Netherlands, pension rights were won at the bargaining table. In Australia, pension mandating was the end product of a classical corporatist agreement between labor and government in which labor won new pension entitlements in exchange for wage moderation.

The most politically significant outcome among these cases is that governments bear no direct responsibility for meeting future earnings-related pension obligations. In the defined contribution design prevalent in Australia, Denmark, Switzerland and some U.K. plans, future benefits depend entirely on

[9] Denmark adopted a very modest second tier earnings based scheme in 1964 but both contributions (about 1.2% of the average wage) and benefits were extremely modest.

contributions and returns on investments so that the problem of "blame avoidance" should future revenues fail to meet expectations is bypassed altogether. Beneficiaries bear all of the risk and future benefit changes can be "blamed on" (or credited to) markets rather than governments. In the Netherlands and the U.K., where a defined benefit design prevails, responsibility for meeting future obligations lies with employers and plan sponsors, not government. Moreover, as these capitalized plans begin to mature in the next century, demand for means-tested benefits is expected to decline, reducing pressure on the tax revenues required for their financing.

This hardly means pension politics will disappear but they will be significantly different, revolving around the role of government as regulator to address problems of market failure and the uneven distribution of benefits among plans.[10] The way these issues are resolved will also doubtlessly reflect the very different processes which brought these plans about. In the UK, capitalization was the result of conservative dismantling and *replacement* of a traditional paygo defined benefit scheme. In Australia, Denmark and the Netherlands, capitalization was the result of a struggle by labor to *supplement* existing plans. Rather than individualized personal retirement accounts, these plans are typically large industry-wide plans in which organized labor remains deeply embedded both in policy-making and administration. Indeed, potential control over large pools of capital was one of the incentives for Australian labor unions to push pension issues to the top of their agenda in the 1980s. How the presence or absence of these quasi-corporatist arrangements affect the resolution of the distributive problems that will inevitably follow in the coming decades is an issue that invites close attention from future researchers.

What of the "latecomers" that have yet to add a second tier of contributory pensions, notably Ireland and New Zealand. Ireland relies on a rather modest flat rate benefit (27% of the industrial wage) and private occupational pensions that cover approximately half of the labor force.[11] The old age dependency ratio will actually decline through 2006 and not begin to rise until the middle of the next century. As a late industrializer with a weak labor party, pensions have not played a large role in Irish politics. Only recently have pensions become the topic of tripartite discussions. The 1998 report of the National Pensions Policy Initiative called for an increase in the flat rate benefit to 34% of the average industrial wage and recommended that employers provide mandatory access to a low cost Personal Retirement Savings Account for all employees with consideration to be given to

[10] These tensions have been very evident in the U.K. where governments have been "blamed" for pension fund failures (the Maxwell affair) and misleading advice with respect to the advantages of alternatives to SERPs.

[11] Pension politics have never occupied a prominent place in Ireland and rather little is written on the topic. The discussion here relies on a personal communication from Julia O'Connor.

mandatory occupational pensions if "insufficient progress" is made in increasing current levels.

In New Zealand, the Labor Party implemented the New Zealand Superannuation Act in 1974, a fully funded state-run defined contribution pension. The plan was attacked by the National Party and wound down after only nine months of operation by the incoming National government in 1976 (Overbye 1997; St. John 1998). Instead, a tax-financed and comparatively generous flat benefit scheme, New Zealand Superannuation (NZS), was implemented in1977. The change was easily accomplished since unlike the contributory plan which would only mature in the next century, NZS began to deliver full benefits immediately. Following the election of 1996, supplementary pensions returned briefly to the political agenda when the New Zealand First Party won an agreement with the ruling National Party to hold a referendum on the addition of a compulsory second tier "savings scheme." Instead, the National Party held the 1997 referendum on a proposal to *replace* rather than supplement the NZS with a compulsory savings plan. The proposal was soundly rejected by over 90 percent of voters.

Interestingly, the traditional explanation for welfare state growth -- the power resources of organized labor and the political left -- has remained salient for the "latecomers." Reforms have made greater progress in those cases where organized labor exerts greater influence. Perhaps the most striking contrast is between Australia, where organized labor remained a partner in the reform process led by the Labour Party in the 1980s and early 90s, and New Zealand where the Labour Party initiated what was perhaps the most anti-labor agenda of any national government over the same period (Castles and Shirley 1995; Grafton, Hazeldine and Buchardt 1997). Yet in the new economic environment of the 1980s and 1990s the form of this labor-led expansion has been quite different from that of pension systems which matured earlier -- funded and occupationally based rather than pay-as-you go and public.

Path II: The Constrained Options of Mature Systems

Funding in Mature PayGo Pension Systems

If whole scale transformation is generally impossible, what of more modest, incremental shifts toward capitalization? Two rich democracies, Canada and Sweden, have taken steps in this direction.[12] And, strikingly, both countries are exceptional by virtue of an earlier history of capitalization. During the start-up period of their national systems (the Canada and Quebec Pension Plans in Canada, the Swedish ATP) in the 1960s, both systems were more or less fully funded. The

[12] Hungary, a country that lies outside the scope of this review, took a more dramatic step toward capitalization in 1997 by shifting 8 percent of payroll contributions (out of 30) into a mandatory DC scheme (Palacios and Rocha 1997).

Swedish funds were used to finance housing. In Canada, the funds of the Canada Pension Plan were lent to the provinces to finance provincial debt but the funds of the Quebec Pension Plan were used to finance both direct and portfolio investment for the development of Quebec corporations.

In 1997, Canada passed legislation to accelerate the projected increase in contribution rates so that additional revenues could be invested in equities by an arms length investment board. This was not a shift toward "privatization" or to a defined contribution design, however. Rather, returns on investments are to be used to finance existing obligations created by the Canada Pension Plan's (CPP).[13] The contribution rate will rise from 5.85% to 9.9% by 2003. The intent is to stabilize the contribution rate at that level, well below the 14.6% level otherwise projected for 2030.[14] This strategy is known as "prefunding", raising the contribution rate sooner than required in order to spread the long term costs over several generations.[15] Legislation pending in Sweden (expected passage, June 1998) will add a 2% payroll contribution to finance defined contribution personal retirement accounts administered by the government. Both the prefunding and personal accounts strategy were presented as possible reform strategies for the U.S. in the 1997 report of the Advisory Committee on Social Security.[16]

Though modest in scope, such reforms add a new element to the policy gene pool but whether the new gene will proliferate and become dominant in the future is indeterminate. To some observers, the addition of personal retirement accounts as in Sweden represents the thin edge of the wedge, a sort of "creeping privatization." Alternatively, the Canadian strategy of investing public funds in the equity market to finance defined benefits could be seen as the beginning of "creeping socialization." The expectations of policy-makers, however, are more modest – to stabilize or supplement the existing system rather than engage in the more radical "paradigmatic reform" advocated by the World Bank. Rather than "radical reform", the principal

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[13] Reserve funds will increase from 2 to 5 years of benefits as a result.

[14] A similar proposal was presented as part of the Advisory Committee on Social Security's Report (1997). Often identified as the "Ball proposal" because it is supported by Robert Ball, for Commissioner of Social Security, it is also identified as the "left wing" solution because of support from labor representatives. In contrast, the Canadian proposal originated within a very conservative Finance Ministry and has received the support of business lobbies and the financial community.

[15] Whether or not such a strategy really lowers the costs to future generations is highly contested among economists For a discussion of this point see Herbert Stein, "Social Security and the Single Investor," *The Wall Street Journal,* Feb. 5, 1997

[16] The 1983 U.S. reform of Social Security also introduced a variant of prefunding: contribution rates were raised but the surplus was invested in government debt rather than in market instruments. The net result is to shift some of the increase in future costs from future payroll taxes to future general revenue financing. Stein's conclusion (see fn. x), however, that reserve funds that are invested in market instruments will have much the same long run consequence.

strategy in the large paygo systems has been to contain expenditure growth through retrenchment strategies that combine across-the-board benefit reductions with program rationalization and increased targeting of benefits.

The Moral Economy of Retrenchment

There is a profound difference between extending benefits to large numbers of people and taking those benefits away (Weaver 1986). For the past half century, expanding social benefits was generally a process of political credit claiming. Not surprisingly, the expansion of social programs had until recently been a favored political activity, contributing greatly to both state-building projects and the popularity of reform-minded politicians (Flora and Heidenheimer 1981). Retrenchment, in contrast, is generally an exercise in blame avoidance rather than credit claiming (Weaver 1986). The strategies available to policy-makers to conceal and diffuse responsibility for cutting benefits by making the effects of policies difficult to detect or by making it hard for voters to trace responsibility for these effects back to particular policymakers are well known. (Arnold, 1990; Pierson, 1994). Successful efforts to trim public sector pension obligations usually take the form of long-term revisions that phase in very gradually in ways that affect only future retirees. The magic of compounding means that incremental reforms which impose relatively small changes in benefits, indexation, or retirement rules can generate very substantial savings over time. When carefully crafted and designed in ways that do not inflict heavy immediate losses on retirees, these reforms have often been introduced with relatively little opposition.

"Policy by stealth" (Gray 1990) , however, is not always feasible, particularly when retrenchment means radically revising well-institutionalized principles of social distribution embedded in existing legislation. As Stinchcombe (1997) recently reminded us, the "old institutionalism" had a great deal to tell us about these matters. One of the main "outputs" of the political system is its own continuing legitimation. Justice, fairness, and the honoring of implicit contracts between policy-makers and the electorate imposes an important constraint on the possibilities for radical reform.[17] Pension systems are essentially a code of laws stipulating who may make claims on the state and under what conditions. Even when a particular moral ethos did not motivate the creation of a particular set of claims (e.g. citizenship pensions were not usually driven by a "philosophy" of social citizenship), *post facto* these legal institutions create a corresponding moral code of what is considered to be just, equitable and fair.

Reneging on past contracts by unilaterally reducing benefits potentially creates a profound problem of legitimacy for governments. Employment-related, defined benefit schemes face a special problem in this regard since the contract is highly individualized. Unlike generic schemes for those in "need" or for "citizens," each individual has his or her own contract with the government with specific

[17] For a discussion of these issues see Myles and Quadagno (1997)

benefits attached to their specific work record, years of contribution and earnings history. Such programs are not just another public service like roads or schools. Instead, they become invested with quasi-property rights in the same way as life insurance or equities. Cutting pension benefits based on contributions is a different sort of exercise than cutting road budgets.

National differences in the success and failure of efforts to cut expenditures through a strategy of “means-testing” benefits for the “rich” graphically illustrate this difficulty. As Myles and Quadagno (1997) show, proposals to cut expenditures by reducing benefits for high income seniors have been widespread. Success, however, has been limited to national schemes in which individuals qualify for benefits purely on the basis of citizenship and residency.[18] Thus far, no country has adopted selective targeting based on income for benefits to which quasi-property rights attach as a result of past contributions, despite concerted efforts and most notably in the United States.[19] The Concord “affluence test” began at $40,000 with a 10 percent reduction rate and an additional 10 percent reduction for every additional $10,000 in income (e.g. at $50,000 there would be a 20% reduction). For families with incomes of $120,000 or higher the reduction rate would be 85 percent so that even wealthy investment bankers would receive some benefits. Some critics of the plan mistakenly referred to this income test as a “means-test” like that for AFDC which tests for assets as well as income as well as very high tax-back rates (traditionally 100% or more).[20]

In parliamentary systems untroubled by elaborate checks and balances or government by coalition, it is technically feasible for a government to introduce and pass whatever legislation it desires and renege on past commitments. Even in such cases, however, the problems of legitimation and “blame avoidance” remain. No government wants to pass legislation that will lead to its defeat in the next election. The problems “blame avoidance” and legitimation for large scale, highly visible, reforms can be overcome, however, if the process of designing the new contract has (or appears to have) the consent of all parties concerned, if all parties are signatories

[18] Since the early 1980s Australia, Canada, Denmark, Finland, and New Zealand and Sweden have adopted some form of selective targeting to reduce formerly universal flat benefits for high income seniors who previously qualified for benefits exclusively on the basis of a combination of citizenship and residency. In 1998, New Zealand abandoned the targeting principle based on income (the “surcharge”) introduced in 1985. However observers expect this return to universality to be temporary (St. John 1998). Only New Zealand and Norway now retain a pure “citizenship” entitlement as traditionally understood in these countries.

[19] During the 1990s,former investment banker and head of the Concord Coalition, Peter Peterson (1993), successfully launched a heated debate in American policy circles over the desirability of “saving” Social Security by cutting benefits for the “rich”.

[20] Why Peterson argued should he, a wealthy retired banker, be receiving benefits from the public purse when he clearly had no need of the entitlements. Ultimately, the Coalition failed in its efforts but not without creating significant support for the proposal which figured prominently in the deliberations of the 1994 Entitlements Commission chaired by Senators Danforth and Kerrey.

to the new contract. Rather than reneging on an existing contract, the contract has simply been renegotiated.

The 1983 reforms in the United States were the product of a highly unusual bilateral agreement between Republicans and Democrats and pending legislation in Sweden is the product of an all-party agreement. Switzerland and New Zealand held referenda on major pension reforms in 1995 and 1997 respectively. The Swiss reform was adopted, the New Zealand proposal was defeated. Legislation for reform of the Canada Pension Plan was introduced after the federal government received the consent of the provinces (which was required by law). The 1995 reform in Italy succeeded after the Dini government won the approval of organized labor whereas the Berlusconi government failed in 1994 when it tried to introduce reforms over the heads of labor. In France, the Balladur government succeeded in 1993 with labor's support while the Juppe government was brought to its knees in 1995 when it introduced legislation without this support. The introduction of mandatory employer pensions in Australia was the product of an Accord between government and the labor unions. Even the exceptions may turn out to prove the rule. In a striking break with tradition, the 1997 German reform was imposed by the Kohl government over the objections of the Social Democrats and the unions (Hinrichs 1998). The Social Democrats, however, have promised to reverse the legislation if they gain power in the next election.

Reaching consensus depends critically on which actors can be considered legitimate signatories to the new contract — the "people" (Switzerland, New Zealand), organized labor (France, Italy), the other political parties (U.S., Sweden)? In Continental Europe and the Nordic countries, the countries with the largest paygo systems, the consent of organized labor has usually been a necessary if not sufficient condition for reform for several reasons. First, unlike Canada, the U.S. or the U.K., where labor is just one "interest" group among many, in these nations organized labor is an "encompassing institution" that represents virtually all employees.[21] Second, the role of labor is reinforced by the fact that in most of these countries the pension system is designed on corporatist principles, administered either by representatives of employers and the unions or by tripartite boards representing government, employers, and labor.. The origins of this pattern lie in the fact that, historically, separate plans were established for different occupational groups (civil servants, white collar workers, blue collar workers, miners, the self-employed etc.). In this way, historical origins are reproduced institutionally in the design of the pension system and labor remains central to any reform process.[22]

[21] Although union membership rates are often much lower, coverage rates — the share of workers covered by collective agreements — is typically on the order of 80 percent (Traxler 1996).

[22] The French case is a striking example. In 1995, the strike by French transportation workers against the reforms of the Juppe government enjoyed broad public support despite the fact that the privileges they were defending (early retirement provisions) were specific to that industry. By failing to reach a mutual accord with the transportation workers the government threatened not the benefits but the principle of labor control over social security programs. As Bonoli and Palier (1996) point

How, then, does one get labor on side? Paradoxically, the reforms to which European labor organizations have given their consent appear to represent a profound shift from the model of old age security defended in the past. Two of the largest reforms since 1990 -- the Italian and the Swedish -- provide especially dramatic illustrations. Artoni and Zanardi (1997:253) conclude that the result of the 1995 Italian reform was to produce a paygo pension design that mimics a capitalized plan in which benefits are calculated on the basis of accumulated revenues plus investment returns ("virtually fully-funded"). Similarly, Palme (1994: 50) describes the 1994 Swedish proposals (which heavily influenced the Italian reform) as a "shift from a system of defined benefits to a system of defined contributions."

To pension *afficionados*, the images associated with such change imply nothing less than a profound paradigm shift in the distributive logic of these welfare states. As Artoni and Zanardi point out, in the old model, the main purpose of the system is to protect the retirees standard of living and benefits were determined by reference to the income earned at the end of one's working life. A pension was essentially a "retirement wage" that should enable the individual to maintain a standard of living similar to that achieved during the working years. Although those with higher earnings paid higher contributions, the notion that there should be a strict one-to-one relation between contributions and benefits was not an intrinsic part of the model. As with defined benefit plans in the private sector, the retirement wage -- its terms and conditions -- is negotiated at the bargaining table. How it is financed is the responsibility of the employer. In contrast under the defined contribution model, all financial risk is shifted to the worker.

The reality is decidedly more complex. The new design implemented in Sweden and Italy is on closer inspection a hybrid of the more familiar (paygo) defined benefit (DB) and (funded) defined contribution (DC) models. To capture the distinctiveness of such plans a new language is required. Following Thompson (1997) and others, we shall refer to it as the notional accounts (NA) model.[23] To assess the implications of the change from traditional DB to the NA design requires closer inspection of the actual mix of design features. As Thompson (1997:6) observes, the promises made by NA models may not be that different from traditional DB designs. One has to examine the actual risks that each model insures.

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out, French pensions are not considered "part of the state." Although the government sets benefit and contribution levels in the general scheme, pensions are considered part of the employment sector and the autonomy of the unions that direct the social security *Caisses* is jealously defended.

[23] The key elements of Thompson's definition of the notional account model include: a centrally-managed, pay-as-you-go, notional contribution plan in which each worker has an account which is credited with the contributions made by or on behalf of the worker. Account balances are credited with the analogue of interest payments calculated either by the rate of increase in the average wage or the rate of increase in total wages.

A key difference between traditional DC and DB models is the protection they provide against economic risks that result from changes in the rate of wage growth and return on investments. As Thompson (1997) demonstrates, in the DC design the contribution rate required to finance a given retirement pension changes whenever wage rates and investment returns change. His simulations of the trends in wages and investment returns in postwar Germany, Japan the UK and the U.S. show there is a very high risk of being wrong – of saving too little or too much. In a DC design "birth is fortune": the year one is borne, and hence retires, creates huge variations in outcomes. Notional accounts plans, like defined benefit plans, carry no such a risk.

When the "defined contribution" metaphor is adopted to describe recent changes in European plans, it is typically used to highlight two rather different elements of reform. The first is a reference to the tendency in *many* European countries to reinforce the link between contributions and benefits by reducing the volume of interpersonal transfers ("non-contributory" benefits). Although decidedly important, neither the presence nor the scale of interpersonal transfers distinguish defined benefit from defined contribution plans. In this respect, the Swedish and Italian systems are simply drawing closer to the traditional German design in which there has always been a tight link between contributions and benefits.[24]

The second element to which the DC metaphor is applied is rather more fundamental. A profound difference between (paygo) defined benefit and (paygo) defined contribution schemes lies in the fact that, in the latter, no commitment is made concerning future benefits; rather benefits are purely a function of revenues and the rules created to distribute those revenues. As Reynaud (1995) puts it, in the DB model benefits "drive" revenues (revenues *must* be raised to meet obligations) while in DC model it is the other way round. A notional accounts model also shares this feature of the DC model though in varying degrees. France adopted a notional accounts design for compulsory second-tier pension systems (AGIRC, ARRCO) in the early 1970s. Individuals acquire pension points based on their contributions and the value of each point is determined only when the entitlement is due based on current and expected contributions, Subsequently, the point's value is reevaluated annually. Plan administrators (in this case the social partners) then face the problem of keeping finances in balance by deciding whether to raise contributions or to reduce benefits.[25] To date, the trend toward the notional defined contribution design is evident in only three nations — Germany, Italy and Sweden.

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[24] As Thompson (1997:19) points out, it is possible to incorporate interpersonal transfers into *any* of the three designs, including the defined contribution model (though to our knowledge this has never been done in DC systems).

[25] The fact that fund administrators have the option to raise contributions rather than reduce benefits, however, means that even the French system is not "pure" with respect to strict DC principles

These two elements of reform have profoundly different implications and we consider each in turn.

Rationalizing Redistribution: The Future of Interpersonal Transfers

Among the most visible change in the Italian, Swedish and other European reforms is the trend toward reinforcing the link, both rhetorically and in practice, between the contributions a worker puts into the system and the benefits she eventually receives. Although benefits have always ostensibly been "earnings-related" most systems incorporate design features that produce at least some measure of inter-personal transfers. Eliminating transfers that can be identified as "inequitable," "perverse" or "out-dated," can provide an effective solution to the blame avoidance problem. If the savings are sizeable, the policy-maker is also in a position to use some fraction of the savings to make "side-payments" to potential critics in the form of new transfers to risk groups now considered to have legitimate claims. The "rationalization" of redistributive design features to achieve equity or to more clearly realize socially desirable distributive outcomes offers policy-makers a potent tool for introducing cuts that are potentially self-legitimating.

A major feature of the Italian and Swedish reforms was the reduction of transfers that resulted from their traditional use of final (or best) earnings benefit formulas, a form of risk insurance against years of low earnings that produced large transfers from workers with many years of high earnings to workers with fewer years of high earnings (e.g. women). Many countries allow people to exclude a certain number of years of low earnings. Italy and Sweden, however, were clearly outliers in this respect. Rather than calculating benefits on the basis of average career earnings and a work history of say 40 or 45 years, Swedish workers were eligible for maximum pensions based on 30 years of contributions and earnings assessed on their best 15 years. In Italy, the earnings record was based on the last 5 years for private sector workers and the last year for public sector workers. Italian workers were also able to claim a pension based purely on years of service (35 years "and out" for private sector workers and 20 years for public sector workers) producing different "rates of return" (and implicit transfers) based on age of labor market entry and employment sector. The reforms significantly reduced the volume of such transfers by introducing formulas that tie benefits much more closely to total lifetime contributions.

The reforms did not eliminate all protection against irregular work histories, however; rather, social protection against irregular work careers were rationalized and *targeted* on specific forms of labor market exit. In the Swedish reform, for example, pension credits are assigned for periods of parental leave, unemployment and illness. As in the past, there is also a minimum guarantee pension. The Italian design imputes a contribution for years raising a child to the age of six and periods caring for disabled family members including parents.[26] In the new design women (and men) get credit if they are out of the labor force *because of* child or elder care but not for providing housekeeping services to a spouse. Men (and women) will receive credit for periods of unemployment or disability (insurable risks) but not for periods of non-employment that is uninsured.

Table 4: Change in Assessed Earnings Period In Final/Highest Earnings Plans		
Country	1986	1996
Austria	10	15
Finland	4	10
France	10	25
Italy	5	Career
Norway	20	20
Spain	8	15*
Sweden	15	Career

Source: OECD, *Reforming Public Pensions*, Paris, 1988 and Social Security Administration, *Social Security Around the World, 1997.* Washington: Office of Research and Evaluation., 1997.

* Changed in 1997

Italy and Sweden are dramatic examples of this change because, among modern welfare states, the volume of interpersonal transfers generated by their traditional paygo design is exceptional. However, the same trend is evident (Table 4) in countries that, like Italy and Sweden, depart from the more common benefit formula that assesses earnings on the basis of a full work life. Although few countries have design features that allow for the dramatic reforms of Italy and Sweden, many have other elements have produced an analogous logic of reform. Among the more significant is the harmonization of retirement ages and contribution years for men and women (Austria, Belgium, Germany, Italy, Switzerland).[27] A share of the savings, however, are typically used to compensate workers for time out of the labor force for child-rearing or care of other dependent family members.

[26] As Thompson (1997:19) observes, it is possible to incorporate solidarity elements of this sort into *any* of the three designs, including the defined contribution model (though to our knowledge this has never been done in DC systems).

[27] Harmonization is in part a result of E.C. directives on gender equality.

The 1995 Swiss reform is especially striking since the reform was *about* introducing gender equality and was subject to a national referendum (Bonoli 1997). As in the U.S., a married man with a dependent spouse was eligible for a “couple pension” corresponding to 150 percent of his own pension entitlement. Women’s organizations successfully took the lead in demanding the end of the “couple pension.” In the new design all contributions paid by the two spouses while married are added together, divided by two, and counted half each. Strikingly, however, couples with children below the age of 16 now receive additional credit equal to the amount of contributions payable on a salary three times the minimum pension (56 percent of the average wage). Childless couples now become penalized for being “free-riders” on the old age security system. [28]

This trend toward reinforcing the link between contributions and benefits is sometimes construed as representing a ‘liberal’ dynamic in welfare state reform, a “re-commodification” of labor (Palier 1997). How then to account for the collaboration of labor in this process? In Continental Europe (Germany, Italy, France, Spain) the demand for reinforcing the link between contributions and benefits, the insurance principle, came from organized labor and the left (Bonoli 1996; Tuchszirer and Vincent 1997). In Sweden, the two main labor organizations, the LO and TCO, have objected to specific elements of the 1994 agreement but not to its guiding principles (Daniel and Concialdi 1997).

The paradox is explained once one identifies the purpose of these demands. Labor’s aim was not to reduce the volume or type of interpersonal transfersbut rather to introduce a clear division of financial responsibility between contributors (“workers”), on the one hand, and the “state” on the other. The upshot of reform, as Reynaud (1997 :11) points out, is to make the division between the contributory and “solidaristic” (redistributive) elements of the welfare state increasingly transparent. Labor’s rationale is straightforward. Henceforth, payroll contributions will be used to finance “earned” benefits while the state will finance the redistributive elements of the system from general revenue. For labor, some of the upward pressure on payroll taxes is relieved. And to the extent that government responsibility is restricted to interpersonal transfers, the problem of “blame avoidance” for future changes in “contributory” benefits is at least partially resolved.

Bonoli’s (1996) interviews with party officials and labor leaders in France and Germany provide striking evidence for the self-conscious character of these demands. In the words of one French trade unionist: "the financing of contributory benefits ...must be done through contributions based on salaries. In contrast non-contributory benefits must be financed by the public purse." German labor leaders and social democrats were primarily concerned about general revenue funding to finance the huge transfers required for pensions in the former East Germany. The

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[28] They were not successful in blocking an increase in the retirement age for women from 62 to 65.

same logic was part of the 1995 Toledo Pact, an all-party agreement supported by both business and labor on the guiding principles for reforming the Spanish social security system (Tuchszirer and Vincent 1997).

Rather than a retreat to "liberalism," the pathway of reform in Continental Europe and some Scandinavian countries more closely resembles a shift "back to Bismarck." As both Palier (1997) and (Guillén 1998) emphasize, labor's eagerness to participate in these agreements has been driven by a desire to preserve the corporatist design of, and hence labor's role in, national social security systems, a major source of union power and influence. And as Schmael (1998) emphasizes, the division between contribution financed insurance and tax-financed interpersonal transfers has long been an organizing principle of the German design. The strategy, of course, is not cost-free for labor since significant concessions must also be made to reach an agreement in which it can be seen to retain its role as "social partner".

The limits of such a strategy are defined by the design of the existing system. The extent to which cuts can be made by rationalizing the distribution of interpersonal transfers depends critically on the volume of such transfers in the old design.[29] Hence, our hypothesis that where the old design generated benefits closely tied to contributions, benefit cuts of necessity are more likely to take the form of across-the-board reductions for everyone and with greater difficulty. The conclusions of Palme and Wennemo (1997) and Schmael (1998) noted earlier with respect to recent reforms in Sweden and Germany may be indicative.[30] But whether rigorous quantitative assessment would support such a claim lies well beyond the scope of this paper.[31]

Increased transparency and targeting generates more , not less, politicization of the redistributive role of the state and as a result is a two-edged sword. On the one hand, it has provided policy-makers with a potent tool for cutting benefits but,

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[29] Though we have chosen not to focus on it here, a parallel argument can be made by distinguishing among countries where rates of early labor market exit are very high (the Continental European countries) and those with comparatively high rates of labor force participation among older workers (e.g. Scandinavia). In all countries tremendous savings could be had by reversing the trend toward "early retirement" and returning to earlier historical retirement ages (e.g. age 65). Thus one would expect the Continental European countries to give special attention to such a strategy.

[30] It is also striking that the recent (1997) German reform, which reduced replacement rates from 70 to 64 percent were made by the Kohl government without the usual consensus of the opposition parties or the unions. The Social Democrats have announced their intention to reverse the legislation if they come to power in the 1998 elections.

[31] Our suspicion, confirmed by researchers at the OECD (Peter Hicks, personal communication), is that quantification of the size and distributional effects of recent reforms is still technically impossible on a comparative basis. Any such quantification would have to make brave assumptions about future growth rates, wages, rates of labor force participation and a host of behavioral responses to these reforms.

on the other, sets the stage for new struggles that can lead to further rounds of benefit expansion. In the past, many of the redistributive features of the old age security system were hidden in complex technical provisions, In the age of expansion, this strategy was often deliberate (Derthick 1978), guided by the assumption that concealment made redistribution politically easier. In an age of retrenchment, increased transparency focuses attention on issues of how much redistribution and for whom. Assigning pension credits for periods of child-rearing, for example, opens up debate over the value of such credits. Women's groups were critical of the modest credits provided by the 1992 German reform with the result that enhanced credits for child-rearing become part of the otherwise cost-cutting 1997 reform. The politics of redistribution has not been abolished but restructured. The outcomes to be explained by future generations of comparativists will doubtlessly include large cross-national variations in the quantity and quality of pension credits for child and dependent care, the unemployed, the sick, and other forms of economic risk.

The far reaching, if still uncertain, implications of these reforms should not be underestimated. Especially important are attempts to reverse the secular decline in the retirement age by creating strong incentives to remain at work until the traditional age of 65 (or later). The 1995 Italian reform raises benefits by about six percent for individuals retiring at age 65 and lowers them by 15 percent for those retiring at 57 (Hamann 1997:16). In Sweden, a worker who contributes from age 22 will have a replacement rate of only 46 percent if she retires age 62, but this rises sharply to 60 percent at age 65 and 82 percent at age 68 (Palmer 1998: 8). Assuming such incentives have the intended effect *and* labor markets provide the required levels of employment, the result of reform may simply represent a return to the status quo of two or three decades ago. If not, the result will be a large benefit reduction for large numbers of future retirees.[32]

A "Hard" Budget Line for Old Age Pensions?

For policy-makers, the Achilles heel of the defined benefit design is the quasi-contractual obligation to raise payroll taxes when expenditures exceed revenues. Raising taxes of any sort under conditions of slow real wage growth poses a problem for governments. But, as we have emphasized, raising *payroll* taxes poses a particular dilemma since higher payroll taxes impose all of the costs on wage income. Several reforms address this problem by attempting to create a "hard" budget line on future benefits so that *post* reform payroll taxes stabilize at a fixed level. Prior to reform, Swedish contribution rates were projected to rise from 17-18% to 24-30% in the next century. The reform aims to stabilize the contribution rate at 18.5% (Palmer 1998: 30). In Germany contribution rates were projected to rise from 22% to 36% between 2000 and 2030. The cumulative impact

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[32] An alternative strategy might have indexed retirement benefits to both expected longevity and current labor market conditions.

of reforms since 1992 stabilizes the rate at approximately 22 percent (Schmael 1998).

One of the ways this is accomplished is especially fundamental, namely the introduction of that *automatically* produce benefit reductions in response to population aging. In essence, contributions will drive benefits an in this respect the new system does resemble a defined contribution model (Thompson 1997: 6). In the German (1997) and Swedish (1994) reforms the benefit calculation at retirement incorporates a “demographic component” to index future benefits to the life expectancy of the retiring cohort. A two year increase in life expectancy among future cohorts, for example, will reduce the replacement rate for a hypothetical Swedish worker who begins work at age 22 and retires after 43 years of contributions from 60 to 53 percent (Palmer 1998: 8). For the “average” German worker who retires at 65 (after 45 years of contributions), the replacement rate falls from 70 to 64 percent (Schmael 1998). The Swedish worker will have the option of maintaining a 60 percent replacement rate by remaining in the labor force for an additional 18 months. The German worker will not have this option.

The Italian reform introduces a similar strategy to ensure that benefits are reduced automatically as labor force growth declines. Under the new regulations, pension contributions will be indexed on the basis of GDP growth rather than real wage growth. The result is that benefits automatically reflect any decline in revenues that follow from slower employment growth. The Italian reform also provides for a review of benefit rates every 10 years to take account of increasing longevity.

Such a strategy is a mirror image of the one introduced during the era of expansion when automatic indexing of benefits was adopted to raise benefits in line with price increases so that adjustment became a technocratic rather than a political exercise. Whether such efforts to de-politicize benefit reductions will work in the same way as earlier strategies to de-politicize benefit increases remains to be seen.[33] One suspects that technocratic retrenchment will produce a rather different response from the electorate than technocratic expansion did in an earlier era. However, if we are correct that the main parties to these agreements (business, labor, government) have a harmony of interest in stabilizing payroll taxes, we can anticipate that future struggles will tend to be resolved through benefits financed from general revenues, that is by enriching interpersonal transfers for selected groups.

Conclusion

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[33] As Winfried Schmael pointed out to us, voters are unlikely to object to benefit increases that result from automatic adjustments; they are likely to be less tolerant, however, when they discover their pension check has been reduced.

Pension reform has been an ongoing process in the OECD countries for well over a decade and will doubtlessly continue well into the next. Hazarding a guess about what the comparative pension landscape will look like 15 or 20 years from now is a perilous exercise since that process is far from complete in most countries and scarcely begun in others. Our analysis has emphasized the strikingly different pathways of reform followed by two broad clusters of countries.

The "latecomers" — nations that had not yet or only recently developed significant paygo defined benefit schemes — have been busy creating a novel form of "welfare state for the elderly," that approximates in varying degrees the model of choice of the World Bank. In this design governments provide a basic tier of protection against poverty but bear little or no direct responsibility for providing standard levels of wage replacement for middle income workers. Indeed, as the funded contributory plans in these nations mature, the demand for government financed income-tested benefits is expected to decline. Here, future pension politics will focus on the regulatory role of government, a role, however, that will create no small measure of political conflict around issues of income *security*. Should capital markets continue to produce high rates of return, *average* living standards among the elderly may be as high or higher as under traditional paygo defined benefit designs but with much more "heterogeneity" (i.e. inequality) of outcomes (Börsch-Stepan 1997). Should capital markets fail to meet expectations and the living standards of the elderly fall substantially, new pressures will emerge for yet another round of reform reminiscent of the of the 1950s and 1960s. The very different institutional environments of these systems, demarcated by the institutional embededness of labor, will play a key role in shaping these outcomes. A battle line already evident in the Australian and British cases are right -left divisions over the promotion of individual retirement accounts versus more collective, industry-wide, schemes.

The second cluster of nations is made up of countries that already had large, mature, paygo schemes in place at the beginning of the 1980s and in particular those of Continental Europe and the Nordic countries (excluding Denmark). Here, we have argued, the options to deal with funding through capitalization are limited and thus far none of these countries have made significant changes in this direction. We have emphasized the obstacle created by the double payment problem, transition costs that make such an outcome unlikely. Overcoming this hurdle is not technically impossible and the transition could be designed to spread the costs over several generations. Apart from modest changes in Canada and Sweden, however, no country has thus far made serious efforts to tackle this hurdle.[34] Instead, reform has taken the path of "retrenchment," typically modest in scale for current retirees or those near retirement but often substantial for future generations as reforms are phased in.

[34] As noted in footnote x, Hungary has taken a more ambitious step in this direction.

In most of these nations, reform has come about with either the active or passive consent of organized labor and we have constructed the analysis in large measure around the apparent paradox of labor consenting not only to cutbacks but also to reforms that seemingly undermine the distributive logic of systems that labor had been so active in constructing in the past. Our resolution of the paradox has several components. First, as encompassing institutions that represent the majority of workers, both active and retired, labor unions must internalize the trade-offs inherent in the prospect of financing ever rising pension demands from the wages of younger workers (Heclo 1988). While all of the consumption of the inactive population must ultimately come from wealth created by the working age population, financing population aging primarily through payroll taxes places most of the burden on wage income; hence, the incentive for unions as well as employers to seek solutions that contain future growth in payroll taxes through shifting the costs of interpersonal transfers from payroll taxes to general revenue. This in turn, however, requires drawing a much sharper division than in the past between "earned" entitlements, on the one hand, and "non-contributory" entitlements on the other as well as reaching new understandings of the meaning of these terms.[35] We have not attempted to account for, or even identify, major variations within this set of nations and this task remains for future work.

[35] It has been difficult, for example, to persuade Italian workers who were eligible for full benefits after 35 years of work, and hence could retire in their early fifties, that a large share of their benefits are "unearned". Such an understanding is premised on an unfamiliar actuarial calculation that includes expected years of benefits as well as years of contribution.

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