5

A New Social Contract for the Elderly?

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Introduction

The democratization of retirement must surely count as one of the great achievements of the affluent democracies in the twentieth century. *Retirement* in its contemporary sense—an extended period of labour force withdrawal driven by the accumulation of sufficient retirement 'wealth' to make work unnecessary—was, until recently, the privilege of the few. In the past, the rank and file of elderly workers were often 'retired' due to lay-offs or disability but not because work was *economically* unnecessary.[1] Even as late as the 1960s, 'old age' was a virtual synonym for poverty in many industrial democracies. All this changed in the past quarter century. Old age incomes have been rising, retirement ages have been falling, and the elimination of old age poverty is now well within the reach of most developed nations.

That today's *elderly* are also *retirees* who, on average, enjoy living standards little different from working age households (OECD, 2001*b*) is the result of two developments. Modern retirement is, in the first instance, a result of the rising affluence associated with the long post-war boom from the 1950s to the 1970s. Today's elderly are able to enjoy a relatively prosperous old age because they enjoyed prosperous working lives compared to their parents who spent their adult years in depression and war.

The *sine qua non* of modern retirement, however, was the widespread reform of public pension schemes during the post-war decades. By itself, rising incomes would have produced a growing share of older employees with sufficient wealth to allow for retirement in advance of physiological decline.

[1] US surveys of new retirees conducted by the Social Security Administration in the 1950s found the vast majority—90 per cent—had 'retired' because they were laid off by their last employer or due to poor health. Less than 5 per cent reported retiring voluntarily or to enjoy more leisure. By the 1980s, involuntary lay-off and poor health accounted for only 35 per cent of retirees and the majority claimed to have left work voluntarily (Burtless and Quinn, 2001: 384).

But without the post-war expansion of mandatory, universal pension schemes that essentially 'democratized' access to retirement, voluntary retirement that results from the 'wealth effect' would still be significantly skewed in favour of those with higher lifetime earnings.

In the twenty-first century, the cost of maintaining the status quo will escalate substantially as a result of population ageing brought about by continued gains in life expectancy and by lower fertility. The net effect is that the ratio of retirees to workers will rise dramatically in the decades ahead: fewer working age adults will be supporting more elderly adults. With very few exceptions, fertility rates in the developed countries have fallen below replacement levels so that, when combined with increasing longevity, the phenomenon of population ageing is likely to continue even after the baby boom works its way through the demographic age structure.

Demography is producing a qualitative as well as quantitative change among the elderly. The fraction of the elderly most at risk of disability, the 'oldest old' (80+), has been growing much faster than the elderly population in general. As importantly, the capacity of the traditional pool of informal care givers (elderly wives, daughters, and daughters-in-law) who provide about three-quarters of all care to the frail elderly (OECD, 1996: 63) is declining relative to this increased demand. Social policy has traditionally focused on the needs for income security and mainstream (i.e. acute) health care. Care for the chronically ill, the physically frail, and the mentally confused elderly is a policy challenge that few nations have begun to meet (ibid.).

It is widely recognized that a second factor, independent of demography, has been raising 'retirement' costs in the affluent nations, namely the falling age of retirement. Part of this decline might be expected simply as a result of rising affluence (the 'wealth effect') so that more workers now acquire sufficient retirement wealth to exit from the labour force at earlier ages. But it is equally clear that a significant share of the decline has been 'policy induced' by both firms and governments. As a result, many older workers face a situation where continued employment simply 'doesn't pay.' These institutional factors clearly vary among countries. We think it unlikely that one could account for the enormous variation in employment rates among the affluent democracies (Table 5.1) simply by reference to national differences in living standards, health status, labour demand, or cultural preferences.[2]

[2] We hasten to add, however, that institutions profoundly shape cultural preferences. Once established, the expectation that 'normal retirement' occurs at age 55 or 60 may be extremely difficult to change.

Table 5.1 Employment rates by age group, 1999

	55–59	60–64
Australia	55	31
Canada	58	34
Ireland	51	36
UK	62	36
US	68	45
Denmark	71	34
Finland	55	22
Norway	77	55
Sweden	77	46
Belgium	37	13
France	53	15
Germany	55	19
Italy	37	18
Netherlands	48	16
Portugal	59	43
Spain	45	25
Average	57	30

Source: OECD, *Older Workers: A Statistical Description* (OECD: Paris, 2001).

The big question for the future is not whether retirement will survive these challenges. It will. Economic growth will be slower than it would be in the absence of population ageing but for the (already) rich democracies, the results will be hardly catastrophic. According to a recent OECD scenario (Turner *et al.*, 1998: 17), real living standards in Europe, North America, and Japan could be 80 to 100 per cent higher by 2050 despite population ageing. While there is good reason to rewrite the retirement contract, there is no reason to abandon it.

Rather, the key issue is whether the progress made in democratizing retirement during the post-war decades is about to erode, and whether further democratization (e.g. equalizing retirement opportunities for men and women) is precluded? Does redesign mean convergence on some hypothetical neo-liberal model for the allocation of retirement wealth, one in which

the rights of citizens contract while the importance of markets expands? Will, in short, the pressures of population ageing on the public budget prove to be an additional source of dualism and polarization in the twenty-first century?

The risk is real. The major impetus for reform since the 1980s has come from rising pressures on the public budget (Schludi, 2001), creating incentives for policy makers to offload the rise in retirement costs to firms and individual workers. In the absence of appropriate regulation, cost-shifting to private sector institutions does raise the risk of an expanded role for markets and diminished democracy in the allocation of retirement opportunities. The risk, however, is diminished by the distinctive character of the politics of pension reform. As the policy record of the past decade has shown (Myles and Pierson, 2001), significant reform is unlikely in the absence of a widespread social consensus among relevant social, political and economic actors. As we highlight later in the chapter, the politics of pension reform typically elicits an unusually intense form of 'democratic' consensus-building. The political constraint on policy makers to reach reform through a 'negotiated settlement' with a broad range of relevant actors makes radical demolition of the post-war retirement contract improbable.

Our optimism about the future is not unqualified however. To produce a modern retirement contract, one adapted to the conditions of the twenty-first century, it is important to recall the conditions that produced the initial contract. Over the post-war decades a rising tide was lifting all boats so that the benefits of economic growth were widely spread.[3] The emergent dualisms and polarization of life chances that began to appear at the end of the 1970s, divisions captured by the new debates over 'social exclusion' (in Europe) or the 'declining middle class' (in North America), were largely absent. Where specific groups, such as the elderly, were apparently 'missing the boat,' support for innovative policy intervention was widespread. The 'risks' associated with old age were perceived as widely shared rather than concentrated among '*les exclus*' or divided between an 'A-team and a B-team'. Our optimism concerning the future of old age in an ageing society, then, is bracketed by the proviso of national 'success' at addressing the policy challenges raised in earlier chapters. Our children and grandchildren will *share* a 'successful' old age to the extent that they also *share* in 'successful' childhoods and work careers.

[3] A remarkable feature of the post-war expansion was that while income inequality did not generally decline neither did it increase. The rich were getting richer but the poor were getting richer as well.

The main policy challenge posed by population ageing *per se* is neither demographic nor economic but distributional. Our demographic future is more or less destiny. Though unexplained, declining fertility is a worldwide phenomenon, unlikely to be substantially reversed by public policy interventions. Immigration may make a difference at the margin and there (inevitably) will be more immigration as young people move from developing to developed countries. But these young immigrants will quickly adopt the fertility behaviour of their host countries and want to bring their ageing parents when they move.[4]

The distributive challenges, in contrast, are profound. As retirement costs rise, how are they to be allocated within and between generations? We can, and no doubt will, offset some significant share of the additional costs by working longer. But can we ensure that that the social welfare losses (reductions in leisure time) associated with longer work careers do not disproportionately affect the least advantaged, those with shorter life expectancies, and low-income workers (who are often the same people)? We can finance the increase in retirement and health care costs by raising the public debt but this simply transfers the costs to future generations, our children and grandchildren. These are the key issues we aim to address here: how to manage the transition so as to satisfy principles of intergenerational equity and intragenerational justice while also contributing to the further democratization of retirement among men and women.

Managing the Transition: Some Initial Assumptions

As usual, the challenge is one of choices and trade-offs. The ten objectives for pension reform embraced by the European Union (Box 5.1) illustrate *grosso modo* the kinds of dilemmas facing policy makers in all affluent democracies in the first half of the twenty-first century.

We want many things simultaneously: *adequate pensions* for all combined with incentives to ensure high levels of *employment*; a fair balance between the *contributions* of workers and the *benefits* of the retired; *flexibility* in the face of societal change but *predictability* of pension benefits. The aim, in short, is to manage the transition to achieve intergenerational fairness, intragenerational solidarity and gender equality while at the same time creating

[4] Though we do not pursue the topic here, we note that to the extent higher levels of immigration form part of a strategy to offset population ageing, policies aimed at successful migrant incorporation are an essential part of the policy discussion on the ageing society.

Box 5.1 The EU's ten principles for pension reform

1. Ensure that all older people enjoy a decent living standard and are able to participate actively in public, social and cultural life.
2. Provide access for all individuals to appropriate pension arrangements.
3. Achieve a high level of employment so that the ratio between the active and the retired remains as favourable as possible.
4. Ensure that effective incentives for the participation of older workers are offered.
5. Ensure that public spending on pensions is maintained at a level in terms of per cent of GDP that is compatible with the Growth and Stability Pact.
6. Strike a fair balance between the working and retired population through appropriate adjustments to the levels of contributions and taxes and of pension benefits.
7. Ensure that private pension schemes will continue to provide the pensions to which scheme members are entitled through appropriate regulatory frameworks and through sound management.
8. Ensure that pension systems are compatible with the requirements of flexibility, security, and mobility on the labour market.
9. Review pension systems with a view to eliminating discrimination based on sex.
10. Make pension systems more transparent, predictable, and adaptable to changing circumstances.

For the exact formulation of these objectives see European Commission, 2001*d*.

conditions for a strong economy and sound public finances. Is it possible to have all of these good things at the same time?

Many of these objectives are mutually reinforcing. For governments everywhere, a major objective is to ensure that increases in retirement costs do not undermine public finances, either by increases in public debt or by 'crowding out' other essential public expenditures. Managing public finances to contain public debt and 'crowding out' effects is a *sine qua non* for achieving intergenerational equity and intergenerational justice since both have inevitable distributive implications in the way the increase in retirement costs is allocated both within and between future generations. Moreover, debt reduction in the short term is necessary to give governments the flexibility to meet rising public costs that will result from population ageing in the long term. However, we see no good reason *a priori* for financing debt reduction disproportionately from the retirement budget and so resist the implicit conclusion that it is desirable or necessary to fix, *a priori*, an upper

limit or 'hard budget line' for future retirement expenditures. Setting 'hard' constraints on the retirement budget undermines flexibility and, we will argue, makes it unlikely that the desired distributive objectives can be realized.

Second, we assume that the distributive objectives, along with those of ensuring adequacy, predictability, flexibility, and transparency, refer to the *entire* 'retirement budget,' not simply to the share that appears on the public side of the national ledger.[5] Current efforts to shift rising retirement costs off the public budget by encouraging diversification of the sources of retirement income among the three 'tiers' of old age security make this assumption especially important. On average, it makes little difference for the working age population whether higher retirement costs are paid for out of tax revenues, occupational pensions, or personal retirement savings. 'Privatization' of retirement costs aimed at stabilizing public finances does not provide a solution to the larger issue of allocating the costs of population ageing between or within generations. Measuring the allocation of rising retirement costs that result from demographic change by reference to the public budget alone under such conditions would, justifiably, erode any public trust in the policy process.

Two implications follow from this last assumption. The first is that national benchmarks or measures of the level and distribution of rising retirement costs must be based on both 'public' and 'private' (= *total social*) costs, not merely the former (Adema, 1997).[6] The second is that any commitment to manage the allocation of costs of population ageing involves not only the redesign of public sector benefits but also a corresponding commitment to the regulation of private sector retirement wealth. The favourable tax regimes available to second and third tier retirement savings instruments clearly warrants that they too be charged with social goals.

Our aim here is not to prescribe a 'one size fits all' design for pension systems in the twenty-first century. It is now widely understood that existing institutional designs severely restrict the menu of feasible options available to policy makers. The large sunk costs in existing pension institutions make

[5] As a recent EU document points out, a 'common emphasis' in recent reforms is to limit the future retirement transfers that 'governments are responsible for' (see European Commission, 2000*e*). But in contrast, see the discussion of these issues in European Commission, 2001*d*.

[6] Such a commitment was made clear in the Commission's communication of 3 July 2001 (Commission of the European Parliament, 2001*b*: 3) which states: 'The present communication responds to the need for clear and integrated strategies to cope with the challenges of an ageing society for pension systems. Such strategies should not only focus on pension schemes belonging to the first pillar as the two other pillars will have an important role to play in achieving the overall objectives of pension systems.'

'regime jumping' highly unlikely for both economic and political reasons (Myles and Pierson, 2001). Rather, we take the status quo as given and focus our attention on the dynamic problem of allocating the *change* in costs associated with sustaining the retirement contract under conditions of population ageing.[7]

We do not have a crystal ball that tells us what the future will bring. We do know, however, that reforms made in the present may have huge 'lock-in' effects that will constrain future generations. Sometimes 'lock-in' effects are desirable: national constitutions, for example, are typically written with precisely this goal in mind. However, we assume that the sad historical record of the social sciences in forecasting future demographic and economic developments will continue well into the future. Accordingly, we attach considerable importance to the principle that a main requirement of any new pension design is that it provides future generations with sufficient flexibility to adjust to the changing circumstances of both the old and the young.

We begin in the next section with a discussion of four key dilemmas policy makers must face when determining how the 'costs' of an ageing society are to be allocated. From these, we derive four criteria or litmus tests for evaluating policy responses to these dilemmas. In the following sections, we move from principle to practise. Drawing on the wide array of national reform initiatives since the 1980s, we highlight both the benefits and trade-offs of alternative reform strategies.

The Economics of Population Ageing: Four Dilemmas in Search of Solutions

Following Thompson (1998), we can highlight the problems facing societies with ageing populations with a simple accounting identity. The economic cost of supporting the retired population is simply the fraction of each year's economic activity given over to supplying the goods and services the retired consume or:

$$\textit{Cost of Supporting the Retired} = \frac{\textit{Consumption of the Retired}}{\textit{Total National Production}}$$

[7] Our focus on *change* rather than *level* essentially bypasses the question of judging the status quo among member states, i.e. whether the current level of retirement costs are too high or too low.

which in turn, following Hicks, can be written as:[8]

$$\textit{Cost of Supporting the Retired} = \frac{\textit{Number of retirees}}{\textit{Number of employees}} \times \frac{\textit{Average consumption of retirees}}{\textit{Average production per employee}}$$

Assuming all else remains fixed, population ageing raises total retirement costs. A 10 per cent increase in the ratio of retirees to workers results in a 10 per cent increase in the cost of supporting the retired. Higher retirement costs are not a problem *per se*. In a stable population (with no population ageing), we might expect future generations to behave much like earlier ones and take some of the gains that result from higher productivity (the 'wealth effect') in the form of more retirement. Population ageing, however, acts as a 'multiplier effect,' raising the costs for the same amount of leisure over each person's life course.

Cost shifting to the private sector does not *per se* change this scenario.[9] Public and private pensions are simply alternative ways for working age individuals to register a claim on future production (Barr, 2001). The share of total consumption of the retired rises irrespective of whether it is financed with state pensions or with investment returns from bonds and equities. Indeed, as Thompson (1998: 44) observes, proposals to shift towards group or personal advanced funded accounts are often made on the grounds that retirees will receive higher returns from their contributions. If this turns out to be true, the effect of change will be to *raise* future retirement costs.

The policy challenge, then, is to determine how these additional costs are to be allocated both within and between generations. The problem facing the rich democracies is not an 'equilibrium' (or point-in-time) problem but a dynamic one: how to allocate the *change* in costs as countries move through the transition.

One solution is to leave the problem of cost allocation to markets and families.[10] In a totally privatized system based on advance funding and other personal assets, the business cycle and changes in demand for labour and capital that are uniquely attributable to population ageing would solve the problem of cost allocation by producing lucky and less lucky generations (Thompson, 1998). Some cohorts and individuals would benefit from

[8] Peter Hicks, personal communication, December 2001.

[9] Advocates for privatization typically argue that the result would be higher investment and hence larger gains in productivity under a privatized system but as discussed later this is a result over which there is considerable scepticism.

[10] On this see the exchange between Richard Epstein and David Braybrooke in Laslett and Fishkin (1992).

favourable wage histories and returns to their capital and so be in a position to retire early in relative comfort. Other cohorts and individuals would be less fortunate and be required to work longer to avoid an impoverished retirement. Families would decide about the intergenerational transmission of wealth so that (perversely), *within* generations, children from wealthy families and with few siblings would be the winners.

For most nations, however, relinquishing the problem of cost allocation to markets and families is not a feasible option for both political and economic reasons, hence utopian. Even if one believes such a choice to be desirable, it is simply not on the menu of feasible options available to most countries since they are not starting from a *tabula rasa*.[11] The possible choices available today are, in the jargon of political economy, *path dependent*, constrained by choices made in the past. For example, because of the high transition costs (see below) associated with moving from a mature pay-as-you-go to a private advanced funded design, the public pension systems now in place will endure well into the future so that policy makers have no option but to make choices about cost allocation. Even in the absence of the economic constraint, the past decade has shown that popular support for established retirement income programmes is both broad and deep so that truly 'radical' reform of this sort faces an equally daunting political constraint (Myles and Pierson, 2001).

There are also sound normative reasons for a public role in allocating the transition costs arising from what is essentially a collective risk created by a changing population structure. We rarely expect markets to allocate the costs of wars or natural disasters. And there is no more reason to have markets allocate the transition costs of the 'baby dearth' in the twenty-first century than of the 'baby boom' of the mid-twentieth century.[12]

To throw into relief the core issues facing policy reformers, it is helpful to begin from an imaginary starting point—a 'useful fiction'—in which all of

[11] The important distinction between *tabula rasa* choices and transformation choices is developed by Orszag and Stiglitz (1999). As they note (1999: 7), the social effects of *transforming* a mature pension system into a system of individual accounts may be substantially different from the social effects of the initial choice between a public defined benefit system and individual accounts.

[12] As Hernes (1976: 516) observes, aggregative outcomes such as marriage, divorce, and fertility rates 'are partly under human control and partly the result of chance processes; in part they can be affected by conscious action but to a considerable extent they are unintended'. Like prices, they depend on all individuals but not on any (one) individual. The normative implications of this observation are important. If one assumes that only individuals, not collectivities (e.g. cohorts or generations), are moral agents, it is difficult on normative grounds to sustain claims (e.g. Thomson, 1996) for allocating the costs that result from such aggregative outcomes to particular cohorts or generations.

the consumption of the retired (including health care and other service costs) comes from pensions financed from payroll taxes on the wages of the non-retired, assumptions that can be relaxed once the main elements of the story are in place.

Needless to say such a starting point more closely approximates the real world situation in countries with highly developed pay-as-you-go defined benefit plans, countries that also were the most active reformers during the 1990s.

Intergenerational Equity[13]

The challenge facing policy makers in the pay-as-you-go countries is in the first instance an intergenerational dilemma that can be illustrated by contrasting two ideal typical pay-as-you-go designs. In the standard defined benefit model with a fixed replacement rate (FRR) common to the majority of developed countries, retirees are entitled to a given fraction of their earnings in the form of benefits plus an adjustment factor to reflect productivity gains and higher wages in the subsequent generation. When the ratio of retirees to workers changes, workers must adjust their contribution rates accordingly. In effect, benefits drive taxes (so that taxes are the dependent variable) and *all of the costs associated with demographic change fall on contributors and their dependants.*

An alternative to a fixed replacement rate is a pay-as-you-go design based on a fixed contribution rate (FCR).[14] The working population is required to

[13] In the context of the issues addressed in this chapter, the principle of *equity* should be understood as referring to 'fair burden sharing', i.e. to an equitable sharing of the costs (or benefits) of demographic transition between citizens. Still, every parent who has tried to explain to younger children why it is 'fair' that they are put to bed before their older siblings knows that determinations of what is equitable are often highly contested. It is not surprising, then, that the contemporary notion of 'intergenerational equity' and its range of application should also be contested (Laslett and Fishkin, 1992). In some contexts, the concept is used to discuss point-in-time differences between generations currently alive (the old, the young), while in other contexts it pertains more to the legacy that one generation (all those now living) will leave to future generations (those not yet born). Here, we make use of both senses of the term (see text below). The range of outcomes considered also varies. Should policies aimed at effecting equity between generations be applied only to the activities of government or to the entire social, economic, and natural infrastructure left to future generations?

[14] It is important to recall that we are describing a fixed contribution model in a *pay-as-you-go* design, not to be confused with a fixed contribution model in a funded scheme where benefits reflect contributions plus (or minus) realized gains (or losses) on invested contributions. Few readers outside of France will be familiar with the pay-as-you-go FCR model. The French model is discussed briefly in the text.

contribute a fixed fraction of its income for the support of retirees. In this design, taxes drive benefits so that benefits are the dependent variable. As the ratio of retirees to workers rises, benefits must decline and *all of the costs associated with demographic change fall on retirees.*

How might a three-generation household faced with the prospect of demographic ageing but committed to intergenerational risk sharing resolve this dilemma? Assuming they are satisfied with the status quo (current consumption levels of the generations relative to one another are neither too high or too low), the solution would undoubtedly approximate the fixed ratio or fixed relative position (FRP) model advocated by Musgrave (1986, Chapter 7).[15] Contributions and benefits are set so as to hold *constant* the ratio of per capita earnings of those in the working population (net of contributions) to the per capita benefits (net of taxes) of retirees. Once the ratio is fixed, the tax rate is adjusted periodically to reflect both population and productivity changes. Along with the fixed contribution method it obviates the need for projections but, in addition, allows for proportional sharing of risk. As the population ages, the tax rate rises but benefits also fall so that both parties 'lose' at the same rate (i.e. both net earnings and benefits rise more slowly than they would in the absence of population ageing).[16]

French second tier pensions (AGIRC, ARRCO) come closest to approximating the Musgrave solution. In theory, second tier French pensions were designed as fixed contribution schemes.[17] In practice, however, plan administrators have discretion to adjust either benefits or contributions and thus can (and do) mediate regularly between the interests of contributors and beneficiaries (Reynaud, 1995). Though not intended as such, the plan's

[15] The FRP principle, however, would not satisfy a concept of fairness defined by the notion that each generation ought to pay the same proportion of salary to get the same level of pension rights during retirement. On a three generational 'family farm,' for example, the *share* or proportion of output required to support ageing parents in retirement under FRP will be larger when there are two producers in the working age generation than when there are four.

[16] This is not the place to engage in an in-depth discussion of the normative merits of reciprocity and equiproportional burden sharing. In line with Musgrave's original approach, stated in terms of the political viability of social security arrangements, we rather note that proportionality indeed often acts as a focal point in negotiation problems (thus lending support to FRP as a benchmark). Political viability, or a policy's sustainability, is not an intrinsic feature of an ideal normative conception of justice. But it is a desideratum, and an important one, when pragmatically implementing a theory of justice. See Vandenbroucke (2001) for a further elaboration of this last point.

[17] In French second tier plans, contributors accumulate credits proportional to their contributions but on retirement the value of these credits is fixed not in relation to their previous earnings but in relation to the total pool of revenue available from contributions made by today's working population.

design would allow it to be run along the lines of a 'fixed relative position' plan.[18] Basic security plans that provide a minimum guaranteed benefit indexed to (net) wages can also be thought of as providing a 'fixed relative position' for less affluent retirees.

The FRP principle says nothing about what the relative position of retirees to workers and their dependants *should* be. It simply provides a rule for allocating the *additional* costs of demographic change between generations once an acceptable ratio is established.[19] From the perspective of multi-generational households facing the prospect of fewer workers and more retirees in the near future, it reflects a joint commitment to maintaining the status quo in relative terms. Just as pension benefits were indexed so that wages and benefits would rise together with increases in productivity, so too FRP in essence 'indexes' *both* contributions and benefits to population ageing.[20]

Our hypothetical three generational household faces a *point-in-time* decision concerning the allocation of costs between generations already alive. Such a situation is very close to the real life political choices facing policy makers both now and in the future: should they raise payroll taxes on younger workers, reduce benefits for retired workers (or those about to retire), or some combination of the two? This perspective is useful since all politics is, in an important sense, 'point-in-time' politics, i.e. in the hands of those currently alive. If payroll taxes rise significantly relative to pension benefits for retirees (the FRR solution), they can anticipate the displeasure of workers and their employers. If, alternatively, real benefits are falling year after year relative to national living standards (the FCR solution) retirees (and those near retirement) will be unhappy.

If we shift our perspective from a 'point-in-time' to a life course framework, however, the case for Musgrave's solution is even more persuasive. What are the implications of the three designs from the point of view of the *entire* life course of cohorts born in the future, the legacy that we will leave to our children and grandchildren?

Under FCR, the living standards of future generations would be preserved during childhood and over their working years but they would experience a sharp decline in living standards in retirement. Under FRR, in contrast,

[18] For a review of recent patterns of reform see Moore (2001).

[19] It should be clear that implementation of FRP does not preclude passing judgement on the current distribution (e.g. that it is too high or too low), making adjustments accordingly, and applying FRP thereafter.

[20] Hence, the FRP design can be distinguished from solutions that index benefits but not contributions to the higher retirement costs that result from increased longevity, the latter being essentially an FCR strategy.

successive cohorts would experience declining living standards in childhood and during the working years but a relatively affluent old age. FRP, in contrast, effectively smoothes the change across the entire life course and maintains the status quo with respect to the lifetime distribution of income. In this respect, FRP is a conservative strategy based on the assumption that, on average, the lifetime distribution of income available to current generations should be preserved more or less intact into the future. Future generations may of course disagree with our judgements and conclude they want a different allocation of income over the life course. It would seem presumptuous however, for the current generation to 'lock in' future generations in advance by adopting either the FRC or the FRR design.[21]

The core of Musgrave's life course argument, however, rests on practical, political, grounds. His main rationale for the FRP model is based on the assumption that neither of the alternatives, FRR or FCR, are *politically* sustainable under conditions of population ageing. They are based, in his terms (1986: 109), on an intergenerational contract that cannot be kept or at least generates great uncertainty about its future. As the opinion polls make clear, under the prevailing FRR model, young, working age contributors are now extremely sceptical that future generations will continue to support a system in which the active population bears all of the retirement costs associated with population ageing. The result is a sense of 'injustice' and cynicism rampant among many young adults as a result of being required to contribute to a system that 'won't be there for me.'

Under FRP, taxes/contributions will undoubtedly increase as a result of demographic ageing, though less quickly than under the FRR design. Thus the FRP principle runs counter to the notion that a 'hard budget line' should be established for contribution levels or that there is an upper ('acceptable') limit to tax levels associated with 'sound public finance'. Implicitly, the assumption of an 'upper limit' implies a level of taxation that will automatically trigger a general application of the FCR model ('no new taxes') in response to changes in the retirement dependency ratio. Thus far empirical evidence and historical experience makes us sceptical or at least agnostic concerning

[21] As Musgrave (1986: 107–8) observes, at any given point in a cohort's life course, those motivated by their immediate (i.e. myopic) self-interest are likely to make choices that depart from the FRP design. For young workers entering the labour force with foreknowledge that the population is ageing, a 'self-interested' response from a cohort concerned mainly with its immediate living standards (i.e. myopic choice) would lead to a preference for a model base on a fixed contribution rate since their contributions to support the retired would not rise during their working years. These preferences, however, would undoubtedly change as they approach retirement since now they would face an impoverished old age relative to earlier retiree cohorts.

claims that there are 'natural' limits to taxation levels that can be known *a priori*. Consequently, we see no sound reason for 'locking in' specific upper limits as long-term policy targets and should leave such a determination to future generations. As taken up below, however, we do think there is good reason for reconsidering the *mix* of taxes used to finance pay-as-you-go pension schemes.

In a dynamic context of change, 'fixed replacement' (FRR), 'fixed contribution' (FCR), and 'fixed relative position' (FRP) can be thought of as alternative principles for the intergenerational allocation of the *change* in retirement costs attributable to changes in the retiree dependency ratio. Moreover, the choice of which principle is applied is a matter of degree. The choice is a normative one that will be determined via 'politics' and it is conceivable, perhaps even desirable, that the mix of choices might change over time in response to changing circumstances.[22] One reason for expecting future departures from the FRP principle, as Frank Vandenbroucke highlights in his Foreword, is that *proportional* sharing measured in income terms does not guarantee *fair* sharing measured in terms of consumption. To use his example, proportional sharing may be unfair if, for example, there are large changes in the relative prices for essential goods and services (e.g. long-term care vs. education and training) consumed by the old and the young. We will assume, however, the FRP principle is the benchmark or litmus test for intergenerational equity, placing the burden of proof on the would-be reformer who would allocate the costs that result from demographic change in ways that depart from FRP.

A major challenge for policy officials is to provide the appropriate accounting frameworks so that the intergenerational allocation of costs associated with any *specific* reform is transparent to the political process. A full accounting scheme of the allocation of retirement costs among the working and retired populations requires inclusion of both the public and private side of the national ledger, including estimates of likely 'behavioural response' to policy changes. Thus, when policy changes intended to induce greater personal saving for retirement are made, the intended (or likely) effect of such change on the intergenerational allocation of retirement costs (including the possibility that retirement costs could rise) need to be established. As Osberg (1998: 135) concludes, policy models that assume there is no linkage between generations *except through the state* bear little resemblance to empirical reality.

[22] The choice of principles might well vary according to the *source* of change in retirement costs. Thus, the FRP principle might be applied to distribute the costs that result from 'demographic change' (i.e. past changes in fertility) while the FCR principle might be adopted to accommodate any decline in retirement ages and some mix of the two to changes that result from greater longevity.

Though we have elaborated our discussion within the context of a national pay-as-you-go design, it is important to highlight that the choice of allocative principles is independent of the financing mechanism in mandatory schemes. Many large corporate sector ('second tier') *funded* schemes have long been run along fixed replacement (defined benefit) as well as defined contribution lines through the use of reserve funds to smooth out temporal fluctuations in returns. A number of countries have been adding partial advance funding to finance existing defined benefit schemes. In a similar way, funded mandatory schemes can be designed to satisfy the FRP principle.

Discussions of *intergenerational* 'equity' must always return to two fundamental points often ignored in such discussions (Osberg, 1998). As highlighted earlier, the aggregate well-being of future generations depends primarily on the quality and quantity of the stock of productive assets (including human capital) they inherit, not on the design of pension systems. Providing an appropriate legacy for a working age population faced with population ageing hinges more critically on the issues taken up in earlier chapters than on pension reform.[23] As importantly, however, the relative size of economic differences *between* generations pales in comparison to those that exist *within* generations. As Wolfson *et al.* (1998) demonstrate, the enormous heterogeneity *within* generations (or cohorts) 'swamps' differences between generations with respect to the distribution of 'winners' and 'losers' that can result from population ageing. It is to this topic that we turn next.

Intragenerational Justice

The *intergenerational* dilemma is compounded by at least three *intragenerational* dilemmas, one among retirees (beneficiaries), a second among the working age population (contributors), and a third by the gender divide within generations.

When pension systems contract: intragenerational justice among the retired

The problem on the benefit side (i.e. among the retired) can be highlighted by comparing a pension system that is expanding with one that is contracting. Expansion/contraction can take two forms: (*a*) an increase or decrease in the number of years of retirement; and (*b*) an increase or decrease in the benefits

[23] As Osberg (1998: 132) writes: 'Future generations will have to combine their own labour power with the physical capital, human capital, environmental resources, and social capital left to them by previous generations . . . Hence, in analysing issues of intergenerational equity, it is crucial to measure accurately trends in these stocks.'

received during retirement. When retirement ages are falling, the social welfare 'gains' in additional leisure and free time tend to go disproportionately to the least well off. An additional year of retirement, for example, represents a larger proportional gain for someone with a 7-year life expectancy than for someone with a 12-year life expectancy. But the reverse is also true: an additional year of employment represents a proportionately greater loss for those with shorter life expectancies. Raising the retirement age for public sector benefits has the largest effect on those without sufficient means to finance early retirement on their own and the least impact on those who do. Since health (life expectancy, disability) and wealth tend to be correlated, the equity problem is compounded.

As with changes in the retirement age, the more disadvantaged tend to gain most when public pension benefits are expanding since they are less able or likely to provide income security for themselves. But, conversely, they stand to lose the most when income security systems are contracting. The standard result from studies of savings behaviour is that the savings to permanent income ratio rises with permanent income and does so in a sharply non-linear fashion (Diamond and Hausman, 1984). The implication is that behavioural response to lower mandatory pensions will be a function of income level: low-income families are less likely to compensate with more savings than high-income families. If a proportional share of the costs of population ageing are to be transferred to retirees, how can this be done so that they do not fall disproportionately on the least advantaged among them? We return to this issue later where we highlight two strategies: (*a*) enhanced minimum pension guarantees for all citizens; and (*b*) a larger role for selective interpersonal transfers in contributory schemes.

Financing pensions: intragenerational justice among the working population

On the contribution side, pay-as-you-go pensions are financed with a tax on wage income—the payroll tax—while income from capital and transfers are exempt.[24] The payroll tax is a flat tax, often with a wage ceiling that makes it regressive. Unlike income taxes, there are no exemptions and no allowances for family size. Low-wage workers and especially younger families with children typically bear a disproportionate share of the cost as a result. These effects are compounded to the extent that high payroll taxes discourage

[24] For purposes of this discussion, we adopt the standard assumption that payroll taxes, even when borne by the employer, are additions to labour costs which are ultimately born by labour typically in the form of lower wages.

employment, especially at the lower end of the labour market where the social safety net, minimum wages, or industrial relations systems make it difficult for employers to pass such costs on to employees. In effect, charging the costs of the transition to the working age population via a payroll tax creates a huge problem of intragenerational equity among the working age population since the distribution of the additional costs in no way reflects ability to pay. Accordingly, in part two, we propose a larger role for general revenue financing in contributory plans.

Population ageing, gender equality, and the gender contract

A third, if often unrecognized, challenge facing policy makers arises from the fact that generations come in two sexes. Men and women face different life course risks both because they are men and women and because of their relations to one another. These differences greatly complicate the pursuit of normative objectives such as intragenerational justice since any particular policy change may result in a differential assignment of 'costs' between men and women. Since women typically have lower lifetime earnings and longer life expectancies than men, they depend more on public pension income in old age and tend to be disproportionately affected by reforms that reduce or restructure public sector benefits. Thus, current reforms aimed at tightening the link between benefits and individual work histories (see below) will have larger effects on women unless adequately offset, for example, by compensating childcare credits. In the past many countries had lower retirement ages for women, differences that are now being eliminated. While arguably more equitable, this makes it difficult for spouses to harmonize retirement ages with each other since husbands tend to be several years older than their wives. Where couples make that choice, women benefit from a longer period of retirement but pay a price in the form of reduced retirement benefits that must support them over a longer life span.[25]

Enhancing gender equality in retirement primarily involves enhancing gender equality over the working life. The reason is obvious: modern retirement is based on a lifetime of accumulating retirement 'wealth' whether in the form of public benefits or private savings. Consequently, proposals aimed at equalising *retirement* opportunities typically emphasise policies that equalise *labour market* opportunities (e.g. day care provision) for men and women during their working lives as much or more than policies aimed at the design or redesign of pension formulae (Ginn, Street, and Arber, 2001).

[25] Differences in life course risks that are the product of the way gender relations are organized make policies to divide retirement wealth (credit-splitting) between spouses at divorce and retirement especially important.

Raising women's labour force participation can be a powerful instrument for offsetting the impact of population ageing. But this may prove difficult where there are large differences in incentives for men and women to engage in paid labour, including gender pay differentials related to retirement benefits.[26] In other words, population ageing introduces more mundane material reasons for gender equalization. As Orloff (2000: 3) observes, issues of gender and care-giving have become central in the contemporary period not only for reasons of gender equality but also because of their broader implications for the economy and the reproduction of the population.

The most difficult challenge, however, arises from constraints on women's labour supply that result from the unequal division of caring work between men and women. Despite the fact that the male breadwinner family model is quickly disappearing into the mists of history, the gendered character of the intergenerational contract remains largely intact (Street and Ginn, 2001). Although dual-earner families are now the norm, women continue to bear most of the burden of reproducing and caring for the next generation and providing care for the older generation.

As highlighted in Chapter 2, issues related to childcare and household reproduction are at the forefront of these debates. Here, we highlight the other side of women's traditional care-giving work, the care of the frail elderly. The rising numbers of frail elderly requiring assistance will generate one of the major 'costs' of population ageing. Working age families but primarily daughters (and daughters-in-law) have been the major providers of elder care, work that generates considerable public savings in long-term care provision and related services (Wolf, 1999). Declining fertility, moreover, creates not only a larger pool of elders requiring care but also concentrates this burden on a diminished pool of potential care providers who are also more likely to be employed than in the past.

Redesigning the Retirement Contract

Pressures for Reform

As the pension systems put in place from the 1950s through the 1970s began to mature in the 1980s and the 1990s, policy makers in all of the large pay-as-you-go countries set about an active agenda of reform that has not come

[26] Issues of pension design that are especially salient for women include: (1) full access to earnings-related pensions for low-wage and part-time employees; (2) elimination of minimum contribution periods as a criterion of eligibility and immediate vesting of contribution-based entitlements.

to an end. Paradoxically, as we shall see, the trend in countries that had *not* developed large, earnings-related, pay-as-you-go schemes by 1980 was expansionary, albeit adopting a rather different design.

The model of choice for the large earnings-related programmes that were created or expanded from the 1950s through the 1970s was the now familiar pay-as-you-go defined benefit (FRR) model. Benefits would be calculated on the basis of some combination of the retiring worker's earnings history and employment history. They would be financed from revenues collected from today's workers via a payroll tax.[27]

For the reformers of the period, the pay-as-you-go model provided a number of advantages, both financial and political. The financial viability of the pay-as-you-go design is typically framed by comparing implicit rates of return in a pay-as-you-go scheme to its major alternative, advance funding in a capitalized scheme in which contributions are invested and benefits financed from returns on investments. The return in the advance funded model depends on long term rates of return to capital (real interest rates). The implicit rate of return in schemes financed by payroll taxes is the annual percentage growth in total real wages (returns to labour). Total wages are the product of the average wage multiplied by the number of wage earners. The latter term is a function of population growth and the rate of labour force participation. Quite simply, then, the financial soundness of the pay-as-you-go design depends on high fertility and labour force growth, high rates of labour force participation, and strong real wage growth.

Given the values of these parameters in the 1950s and 1960s—rising wages and a growing workforce—and without a demographic crystal ball, most treasury officials would have (sensibly) advised their ministers to opt for a pay-as-you-go design. Pay-as-you-go also pre-empted objections to state control over large capital pools and sidestepped 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, pay-as-you-go systems offered enormous 'front-end' political and social benefits during the initial phase-in period. Since there was no preceding generation of entitled pensioners, politicians could immediately offer a potent combination of modest payroll taxes, generous promises of future pensions and, importantly, address rampant old age poverty immediately rather than waiting for

[27] In the start-up phase, a few countries (Canada, Sweden) adopted some measure of advance funding by investing surplus revenues to create future flows of revenue but these investments declined as the plans matured. Others provided for some measure of general revenue financing to meet unexpected shortfalls or to subsidize some forms of interpersonal transfers ('unearned benefits') but in most countries payroll taxes have provided the bulk of the revenue.

Table 5.2 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.

the plan maturation required of an advance funded design. By the 1990s everything had changed. Figures for Canada are illustrative (Table 5.2).[28]

Clearly by the end of the 1980s a 'sensible' treasury official would be advising her minister that the model put in place in the sixties was in difficulty. The conditions that favoured the pay-as-you-go design in the 1960s—strong labour force and real wage growth—had evaporated as a result of declining fertility, relative economic stagnation and high rates of unemployment. To meet future obligations, payroll taxes on current workers would rise inexorably into the future. In the context of relatively slow real wage growth and high levels of unemployment, the downward pressure on take-home pay created an intergenerational dilemma for trade union leaders as well as for employers and treasury officials.

For good or for bad, a wholesale shift from pay-as-you-go to advance funding was not an option for most pay-as-you-go countries by the 1990s. Once mature, a pay-as-you-go scheme acquires a large implicit debt reflecting benefits owed to current retirees and those already earned by current workers. Over some period of time, contributors (or taxpayers) must pay twice: once to fund their own pensions and again to fund the large implicit debt built up by the existing pay-as-you-go design. Analyses of the transition costs for the major industrial countries show that the costs of servicing this debt is likely to be greater than the cost of establishing sustainable contribution rates under their pay-as-you-go pension plans (Thompson, 1998: 128). To solve the public finance problem, these nations set about revising benefit formulas, financing mechanisms, and related reforms aimed at containing the growth in contribution rates that would otherwise occur. Public sector reform was

[28] Similar, if less graphic, illustrations for selected European nations can be found in Davis (1995: 37).

often accompanied by reforms aimed at facilitating and encouraging a larger private sector share in future retirement incomes.

The pattern in another set of countries—the 'latecomers'—was rather different. These were countries that had developed no, or only modest, earnings-related pay-as-you-go schemes by 1980 and included Australia, Denmark, Ireland, the Netherlands, New Zealand, and Switzerland. With the exceptions of Ireland and New Zealand, the trend among these countries since 1980 was towards pension *expansion* by means of growing coverage of employer pensions based largely on advance funding rather than pay-as-you-go financing. Switzerland and Australia introduced mandatory, advance funded, defined contribution plans for the whole of the labour market in 1985 and 1992, respectively. Denmark and the Netherlands reached the same outcome—quasi-universal employer plans—at the bargaining table.[29] The UK joined this group in the 1980s when participation in SERPS was made optional and employees were allowed to 'contract out' of the public scheme. The UK was a quasi-latecomer, introducing its earnings-related pay-as-you-go scheme only in 1978 so that by the mid-1980s the implicit debt to be financed was comparatively modest.

In large measure, the latecomer countries, by adopting advance funding and (typically) defined contribution designs have avoided the *public finance* problems induced by population ageing but not the larger economic challenge. As these plans mature, the economic costs of supporting the retired will increasingly occur off budget but will be no less real. Reforms in the large pay-as-you-go countries aimed at reducing public sector costs by encouraging private sector alternatives will have a similar impact. Whether or not private sector advance funded plans also alter the economic cost of supporting the retired depends on their impact on one or other of the ratios in the accounting equation presented earlier.

1. If advance funding raises the level of savings and investment so that productivity gains are larger than under existing arrangements, then total production may rise, and everyone will enjoy higher living standards. The economic literature is generally agnostic about such an outcome, however, since additional pension savings tend to displace other forms of saving.
2. If advance funding, as is often claimed, provides contributors with a higher rate of return than pay-as-you-go alternatives, then the living standards of retirees will rise and total retirement costs also rise as a result. In periods when investments perform poorly, benefits will decline and retirement costs will fall.

[29] Danish plans are defined contribution while Dutch plans are typically defined benefit.

3. Depending on fund performance, 'lucky' generations will be able to retire sooner and retirement costs will rise; the reverse situation is likely for cohorts whose funds perform poorly.

The main lesson is that meeting policy objectives such as ensuring intergenerational fairness or maintaining solidarity within generations cannot be achieved without considering the retirement income system as a whole (the public and the private side of the national ledger). The average effect of an increase or decrease in retirement costs on the working age population is the same regardless of which financing mechanism is used.[30] Public sector costs in the United States are low relative to say Sweden but total retirement costs are undoubtedly higher. *Average* relative incomes of US retirees are somewhat higher than in most European nations (Hauser, 1997) and health care costs are also greater.

Shifting retirement costs off the public budget does not imply politics and policy making become irrelevant. In the 'latecomer' countries, for example, future pension politics will focus less on the role of the state in 'taxing and spending' and more on its role as market regulator and to provide remedies for 'market failure.' Similarly, regulatory policy will rise in importance in the traditional pay-as-you-go countries as initiatives to encourage expansion of second and third tier pensions begin to have effect.

For the pay-as-you-go countries, the main target of pension reform in the 1990s was to slow or freeze the rate of growth in payroll contribution rates. This aim is most dramatically represented by reforms aimed at imposing 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 per cent in the next century. The reform aims to stabilize the contribution rate at 18.5 per cent (Palmer, 1998: 30). In Germany contribution rates were projected to rise from 22 to 36 per cent between 2000 and 2030. The cumulative impact of reforms since 1992 stabilizes the rate at approximately 22 per cent (Schmael, 1998).[31]

In our imaginary world where all of the consumption of retirees is financed by payroll contributions, retirement ages remain fixed and the population is ageing, putting a brake on contribution rates, as we have highlighted, places

[30] The numerous 'myths' surrounding the supposed advantages of funded individual accounts have been examined (and exploded) by Orszag and Stiglitz (1999) and Thompson (1998) and we do not pursue these issues further here.

[31] In Italy, Germany and Sweden an important strategy in this regard is the introduction of a 'notional accounts' design that transfers the risk of future demographic change from contributors to beneficiaries. These include indexing future benefits to increases in longevity or to future GDP growth.

all of the costs of population ageing on the elderly and, by definition, their relative living standards must decline. The potential result is a world more akin to the situation of the elderly of the 1950s than of the 1990s. Fortunately, the real world is more complex. Redesigning the retirement contract requires consideration of the three major components of the retirement income system: the age of retirement, the benefit structure, and the method of financing retirement incomes. We consider each in turn.

Working Longer

Among public policy makers (see OECD, 1998, 2000*a*, 2001*b*), though not necessarily their publics, there is considerable enthusiasm for solutions that keep workers in the labour force longer thereby reducing the retiree dependency ratio. There is good reason for this enthusiasm. The three main reasons why workers exit from the labour market at advanced ages are health, wealth and labour market redundancy. Trends for two of the three suggest considerable optimism that future cohorts could retire later. The 'good news' about growing old in the twenty-first century includes:

- *Increased longevity*: People are living longer which adds to the cost of retirement pensions but also means that somewhat later retirement will not reduce the number of years the average person will have to enjoy retirement.
- *Improved health status*: In general, the health of persons in their sixties has been rising. There is greater reported prevalence of some chronic illnesses (heart disease, hypertension) in older cohorts since these diseases are less likely to lead to early death than in the past but the numbers reporting significant activity limitation has declined substantially (Pransky, 2001).
- *Changing work conditions*: New technologies and post-industrial job structures have reduced the number of jobs requiring strenuous physical effort (Manton and Stollard, 1994).
- *Rising educational and literacy levels* among younger cohorts should reduce one of the major barriers to continued employment among older workers and improve the likelihood of successful retraining at advanced ages.
- *Changes in labour demand*: Perhaps the strongest force working in favour of later retirement ages in the coming decades is the effect of population ageing on labour demand. Slower labour force growth drives up capital–labour ratios so that real wages tend to rise and interest rates to fall. Higher real wages create incentives to remain in employment. Lower interest rates reduce income flows from retirement savings. Under these conditions,

healthier and more skilled workers faced with an age-neutral pension regime may increasingly 'choose' to remain at work longer and employers to adapt employment conditions to be more 'friendly' for older workers.

Given these favourable conditions for an extended working life, the case can also be made that the result of later retirement may be more benign than its alternative, namely reduced living standards for retirees and workers. If the labour market is able to generate sufficient employment to absorb older workers and raise total employment levels, a potential payoff is greater economic growth and higher living standards for all. Recent OECD (2001: 69) estimates show that the effect of small increases in the average retirement age can have an equal or greater impact on retirement costs than large cuts in retirement benefits.[32] Moreover, on average, the potential 'welfare loss' that might otherwise result from a longer working life will be offset by increased longevity. Since people are (and will be) living longer, *more* working years does not mean *fewer* retirement years.

Policy makers face a formidable political obstacle to implementing later retirement ages. Most workers in most countries look forward to retirement and raising the age of eligibility for retirement benefits is among the least popular reform options. The OECD, however, highlights an important contradiction in popular preferences for retirement. Though most people are opposed to legislating later retirement, the majority of actual retirees indicate that their preferred status would be to have part- or even full-time employment. The authors (OECD, 2001*b*: 82) conclude that the explanation for this apparent contradiction is that the retirees 'were likely thinking of hypothetical, highly desirable jobs that were particularly suitable for them—ones that are in limited supply for most people'. If correct, these results underline the importance of the issues of job quality raised in Chapter 4.

As highlighted at the beginning of this chapter, rising retirement ratios have three distinct sources: past changes in fertility, increased longevity, and falling retirement ages induced by both governments and firms. As explained in the footnote, of these three, the clearest *normative* case for policy intervention can be made with regard to eliminating inducements created by

[32] Simulations for a 'stylized' OECD country indicate a 5 per cent reduction in the number of beneficiaries—equivalent to an effective rise in the retirement age of 10 months—is equivalent to a 10 per cent cut in average retirement benefits. The reason for the difference can be understood by referring to the accounting equation introduced above. An increase in the retirement age changes both the numerator and the denominator of the retiree/employee ratio. A reduction in benefits affects only the numerator of the ratio between the average consumption of the retired and average productivity per worker. I am grateful to Peter Hicks both for the equation and for pointing out its implications to me.

firms and governments to encourage future generations to choose more retirement and fewer working years.[33]

Reversing the downward spiral: the culture of early exit

In many countries, labour market conditions in the 1970s led to the view that early labour market exit by older workers was a socially and economically acceptable alternative to high unemployment among younger workers. Pension systems often became used as pseudo unemployment schemes and unemployment and disability schemes as pseudo pension plans. The result, as Guillemard (2001) highlights, was a downward spiral in the expectations and practises of both firms and workers. Both employers and workers began to view age 55 as a 'normal' age for definitive withdrawal and those beyond 55 as essentially redundant and unemployable. The results 'ricocheted' onto workers in their forties and early fifties as they became defined as employees 'on their way out', workers without a future and hence inappropriate targets for retraining.

What is striking about such changes is the speed with which they became institutionalized. Rather than being viewed as a temporary stopgap measure (e.g. to respond to cyclical downturns in the economy), the introduction of early exit options quickly became established as a permanent 'structural' shift by both sides to the labour contract. For many, the phrase popularized by a large Canadian firm to market their retirement financial services—'*Freedom 55*'—became the new standard for 'successful' completion of the economic life course. As Guillemard observes, altering such norms takes more than just reducing incentives for early exit but also requires creating positive incentives for employers and workers to extend employment beyond the expected retirement date since both sides tend to develop large sunk

[33] To establish a normative benchmark for changing the retirement age, it is helpful to rethink the way we organize the economic life course in light of our earlier discussion of intergenerational equity. From a life course perspective, intergenerational equity suggests that we hand on to our children a potential life course at least as good as our own. A 'fixed relative position' solution to the division between work and retirement given no economic growth but increased longevity implies a one-for-one trade-off: for every one year increase in the average life span, future generations would work one additional year. However, as earlier generations and we have done, the additional working time would be reduced (be 'indexed') to reflect economic growth that results from higher productivity so that the additional working time would be less than a year. What to do with additional costs that result from past changes in fertility? Implicitly, the FRP principle simply indicates that these costs should be 'smoothed' over the entire life course of future generations. However, it says nothing about *what* should be smoothed—consumption or leisure. Efforts by the current generation to decide whether our children will absorb these 'costs' with less leisure (later retirement) or lower life-time income are likely to be frustrated in any event. They will make up their own minds. In contrast, eliminating *incentives* created by the current generation that *bias* the choices our children will make with respect to these issues is entirely consistent with Musgrave's FRP principle and intergenerational equity.

costs, social as well as economic, around expected retirement timetables.[34] If, as anticipated, labour demand rises in the twenty-first century as a result of population ageing, the market may deliver these incentives. Guillemard, however, notes that both the Netherlands and Finland have had success in reversing the trend to early retirement not just by closing off (or narrowing) 'pathways' to early exit but also by opening up new pathways for continued employment.[35]

Regulating access to retirement wealth

The most powerful force driving early exit from the labour market—economic growth—is also benign but works in the opposite direction, that is to encourage retirement. As Burtless and Quinn (2001: 385) conclude, the 'simplest and probably most powerful explanation for earlier retirement is rising wealth'. National GDP in the affluent democracies has grown dramatically in the last half century and some of this increase has been used to purchase more years of retirement. Moreover, while working years and working hours have declined for individual workers, they have risen for families, a result of higher women's participation. The increase in 'family' years and hours worked helps pay for more years of retirement. For future cohorts, the same factors that make work possible to more advanced ages—better health and education—along with productivity gains will help compound the wealth effect: they will earn more and accumulate their wealth sooner. Future gains in female employment will add to this effect.

In nations where most pension 'wealth' is stored up inside public sector retirement schemes, policy makers have considerable discretion over the age at which individuals can gain access to it. Where public sector benefits provide a smaller share of retirement income (e.g. Canada, the US, the UK), the effects of raising the age of entitlement inside *public* plans may be more modest and even perverse for both macroeconomic and distributive reasons. The largest gains to the economy are to be had if the most productive workers (the healthy, well educated, and presumably better paid) remain in employment longer. Reform can have a potentially perverse effect if changes to retirement incentives in public sector plans mainly produce higher retirement ages among low wage, low productivity workers. In the US, for example, where public sector benefits provide a comparatively small (about 40 per cent) share of retirement income, most studies conclude that even large changes in Social Security rules regarding the retirement age cause only small changes in the actual retirement age (Burtless and Quinn, 2001: 405). Higher income earners with greater pension and private wealth outside Social Security are particularly immune to such changes.

There is considerable variation in this regard. High-income pensioners in Canada, Japan, the Netherlands, and the US receive less than 10 per cent of their income from public sources and, in Britain, just over 10 per cent. In Italy the figure is about 50 per cent and in Germany and Sweden between 60 and 70 per cent (OECD, 2000*a*: 44). In Canada, where high income groups depend largely on occupational pensions and personal retirement savings, there is a much higher level of early retirement (before age 60) among professional and managerial than among less well paid occupations (Schellenberg, 1994: 22–3). In Germany, by contrast, workers in higher status occupations rely heavily on public pensions and are less likely to retire early than employees in lower status occupations (Kohli, 1995).

The implication is that reforms aimed at raising retirement ages requires identical rules regulating the age of access to pension wealth in all three tiers of the pension system. Where co-ordination does not take place, public sector reform is likely to have perverse distributional and macroeconomic outcomes.

In the more market-oriented pension regimes of the Anglo-Saxon countries and Ireland, future trends in the retirement age, not surprisingly, depend largely on regulating access to second and third tier pensions. Raising employment incentives inside *public* schemes will have modest effects and mainly impact lower wage earners that receive a larger share of their retirement income from the public budget. In these nations, raising the average retirement age for higher income employees depends more on co-ordinating the age of access to employer plans and personal retirement savings with public sector plans. Policy co-ordination among public and private sectors will also grow in importance in Denmark and the Netherlands in the twenty-first century as the quasi-universal employer plans negotiated by the social partners in the 1980s come to maturity.

The *fiscal* (public finance) challenge posed by population ageing is greatest, however, where large 'encompassing' pay-as-you-go defined benefit plans were created to provide the vast majority of retirement income not only to those with modest incomes but to middle and upper-middle earners as well. The upshot, however, is that governments in these countries also have the greatest capacity for regulating retirement ages across the whole of the labour market, for high as well as low income earners.

[34] Workers develop 'life plans' in anticipation of retirement that involve career, financial, and housing decisions that may affect not only them but younger family members as well. Firms develop recruitment, training, personnel, and wage strategies based on assumptions about probable rates of exit.

[35] In the Netherlands, Guillemard (2001: 6) notes, not only have benefits for disability been reduced, access to benefits also now depends on employee rehabilitation.

Protecting the least advantaged

The challenge, of course, is to ensure that the social welfare losses (reductions in leisure time) associated with these reforms do not disproportionately affect the least advantaged, those with shorter life expectancy and low-income workers (who are often the same people). While average health status is rising among older workers, it is still the case that the proportion that is disabled rises as a cohort ages.[36] Retirement pensions are clearly a blunt instrument for dealing with the disabled minority. However, they obviate the need for, and the administrative costs of, a carefully tuned system able to identify the 'truly' impaired. Meeting this challenge requires the bureaucratic and technical capacity to administer early retirement schemes for reasons of disability and labour market redundancy that are fair and perceived to be so by the larger community. The other side of an active labour market strategy aimed at reversing the 'downward spiral' are better and more effective programmes for the truly disabled and those whose 'human capital' cannot be raised above the minimum level necessary for employment.

By definition and design, old age *insurance* is a mechanism that transfers income from those with shorter life expectancy to those with greater life expectancy.[37] The result as noted, earlier, is that falling retirement ages disproportionately benefit those with shorter life expectancies but the converse is true when retirement ages are rising. Since life expectancy is associated with economic status, old age *insurance* by definition creates an implicit transfer from the poor to the rich. Hence, this yields one clear rationale for compensating vertical transfers, a topic we turn to in the following section.

Redesigning Benefits: Intragenerational Justice among the Retired

Until the second half of the twentieth century, public pension benefits reflected traditional assumptions of *social assistance* rather than contemporary notions of *social security*. Benefits were modest and aimed mainly at putting a floor under the declining wages of older workers and a modest income for their widows. Early post-war reforms hardly changed this. Where they existed, replacement rates in earnings-related public sector plans were modest. Beveridge-type reforms that introduced universal flat benefits for all, contained no notion of providing retired workers with an income sufficient to maintain pre-retirement living standards, i.e. *income security*. Germany in

[36] US studies of recent Social Security recipients aged 62–64 indicate that approximately 22 per cent have impairments that prevent employment.

[37] In the United States, for example, it has long been noted that Social Security creates a transfer of wealth from blacks to whites.

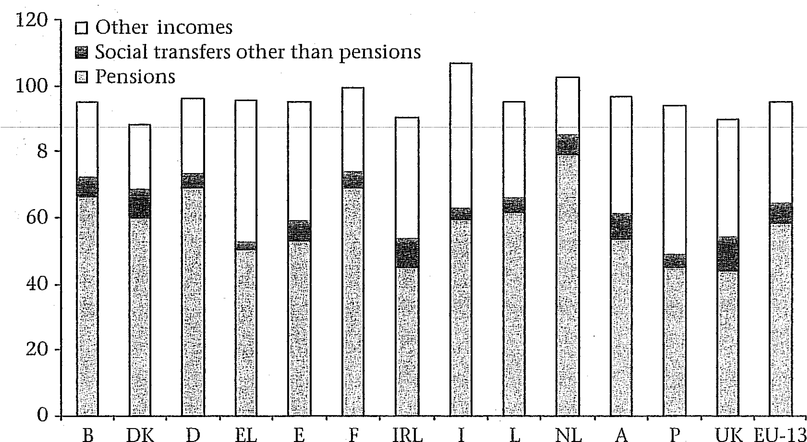

Chart 5.1 Relative equivalized income of persons living in households receiving pensions (100 = all persons in a given country)

Notes: The average (equivalized) income of the whole population in a given country is put at 100. Pensions include retirement and survivor's pensions. For EU-13, persons living in households benefiting form pensions have an average income of around 95%. This means that their average standard of living, as measured by income, is 5% lower than for the total population.

Source: Social Protection Committee on the Sustainability of Pensions, May, 2001.

1957 and Sweden in 1958 took the lead in this respect and, in varying degrees, most countries followed suit in the sixties and seventies. The aim of the new design was to provide retired workers with a retirement wage reflecting past earnings, a form of retirement insurance traditionally available only to civil servants and a minority of private sector workers through their employers. As illustrated in Chart 5.1, *average* living standards of retiree population (pensioners) in Europe now differ little from the rest of the population despite differences in pension design and the OECD (2001*b*: 27) shows identical results for Canada, Japan, and the US. The gap between the old and young would be further reduced if differences in home ownership were taken into account.[38]

The relative economic status of recent cohorts of retirees is not merely the result of better pensions, however. They also reflect cohort history. Today's

[38] There is considerably more cross-national variation in the proportion of older persons who might be considered affluent relative to their nation-specific income distributions. LIS calculations for Italy, France, Spain, and Germany show that between 30 and 34 per cent of elderly households are in the top two population income quintiles. In Sweden and the UK the proportion is 23 per cent and in Denmark and Finland 14 and 17 per cent respectively.

seniors are the workers of the golden age. They have comparatively high incomes today because of relatively affluent work histories compared to earlier cohorts of old people whose adult lives were spent during depression and war. Moreover, current retirees have grown old in a period of slower real wage growth among the working age population. Had real wage growth during the past twenty-five years been like that of the previous twenty-five, the elderly today would look less affluent simply because the incomes of the working age population would be much higher.

The lesson here is that the current economic situation of old people is an uncertain guide to what is good and what is bad about the current design of pension systems. It reflects not only the design of the pension system but also cohort specific life experiences. To anticipate the future we must make assumptions concerning: (*a*) what the economic history of today's workers will have been like when they reach old age (relatively affluent or not); and (*b*) what the economic circumstances of the working age population in the future will be like. How does one design a system to allocate the costs of population ageing in the face of such uncertainty. As we noted earlier, the criterion of Fixed Relative Position not only provides a benchmark for intergenerational equity but also has the advantage that it requires no assumptions about the future values of these parameters. The FRP principle essentially allows for intergenerational risk sharing to accommodate the varying fortunes of sequential cohorts.

Unlike the traditional fixed replacement ratio design, however, FRP assumes that a share of these costs will be allocated to future pensioners—benefits will be lower than under the FRR design. This result raises issues of intragenerational justice among the retired: how to allocate these costs so that they are of greatest advantage (or the least disadvantage) to the least well off within the pensioner population?

Clearly, reforms that simply cut all pensioner benefits by a proportional amount (e.g. by reducing all pensions by 5 per cent) do not satisfy this standard. Moreover, behavioural response to such reductions can be expected to increase inequality among the retired. The standard result from studies of savings behaviour is that the savings to permanent income ratio rises with permanent income and does so in a sharply non-linear fashion (Diamond and Hausman, 1984). The implication, then, is that behavioural response to reduced *mandatory* pensions will be a function of income level: lower income families are less likely to compensate with more *voluntary* retirement savings than higher income families.

The notion that the costs of restructuring should be born by those most able to afford it and the weakest members of society should be protected is hardly novel. But how to implement it? Here, we propose two forms of 'targeting' benefits to meet this challenge drawn from the real world experience of Member States and other OECD nations.

Eliminating Old Age Poverty

Declining poverty rates among the elderly have been a distinguishing feature of all OECD countries since the 1960s. Old age poverty rates below 10 per cent are now common and a number of countries have achieved rates of 5 per cent or less (Hauser, 1997; Smeeding and Sullivan, 1998; and Table 5.3).

The most effective anti-poverty systems are not necessarily the most costly. Both high-spending Sweden and low-spending Canada achieve poverty rates of less than 5 per cent (see also Smeeding and Sullivan, 1998) as a result of the fact that both provide guaranteed minimum benefits that raise the vast majority above standard 'poverty lines'. Canada provides a guaranteed annual income to the elderly and Sweden a guaranteed minimum pension. Both make benefits conditional on the presence or absence of other economic resources but in a way that departs significantly from traditional *means-tested* programmes. To distinguish traditional means-testing from these modern variants it is useful to draw some distinctions.

- *Means-testing*: Individuals qualify for benefits on the basis of a test for both *income* and *assets*, requiring individuals to 'spend' their way into poverty to qualify. Tax-back rates (the rate at which benefits are cut as other income rises) are typically high and can be in excess of 100 per cent. Supplemental Security Income (SSI) in the United States is an example. Usually the aim is to restrict benefits to a small fraction of the population (the 'poor'). Because of the intrusiveness of the means test, there is often considerable stigma attached to accepting benefits so that take-up rates tend to be low.

Table 5.3 Poverty rates among the population 65+, 1990s

<5%	5–9%	10–14%	15–19%	>20%
Canada	Finland	Austria		Australia
Sweden	France	Belgium		US
	Germany	Denmark		
	Luxembourg	Italy		
	Netherlands	Norway		
	Switzerland	Spain		
		UK		

Source: LIS Key Figures, Luxembourg Income Study, 2001.

- *Income-testing*: As the term suggests, income-testing is based on a test of income but not of assets so there is no requirement to spend oneself into poverty to qualify. Interest or dividends from investments are included in the test but not the underlying capital that generates the income. Tax-back rates are always *much* less than 100 per cent so that benefits are not 'for the poor alone' but often extend well into middle income groups, albeit at declining rates. The implicit model is closer to Milton Friedman's design for a negative income tax (NIT) or a guaranteed annual income (GAI) than traditional means-tests for the 'poor' (see Myles and Pierson, 1997). Canada's *Guaranteed Income Supplement* for seniors is the exemplar.[39]
- *Pension-testing*, as practised in Sweden and Finland, is a yet more restricted type of test, including only income that comes from *public* pension programmes in those countries. Unlike a Guaranteed Annual Income scheme, it functions to provide a Guaranteed Annual Pension. Individuals with earnings histories and contributions below the minimum, are provided with pension supplements on a sliding scale. Where all or most of the income of retirees comes from the public pension system, of course, the distinction between income and pension testing is merely a formal one.

Providing all citizens with a minimum guarantee above a poverty line indexed to national living standards is well within the reach of most member states since the poverty gap—the difference between family income and the poverty line—of the poor elderly is typically modest compared to that of working age families (see Table 5.4).

Providing retirees with a high guaranteed annual income or minimum pension is less problematic than providing such benefits to working age families since the issue of work incentives does not arise.[40] Over some range of the earnings distribution, a high guarantee level may have an impact on

[39] Every NIT model is defined by three parameters: the *guarantee level* (the level of benefit provided to people with no other income; the *tax-back rate* (the rate at which benefits are reduced as the recipient gains income); and the *break-even point* (the income level at which benefits disappear). A high guarantee level is desirable to provide people with adequate incomes and a low tax back rate is desirable to encourage people to work. But such a combination means that the break-even point is very high and so are the costs. In practice, virtually all NIT proposals are broken into two tiers in order to contain costs and to maintain work incentives. One tier is intended for people who are not expected to work (such as the elderly) with a high guarantee level, a high tax-back rate, and a low break-even level. The second tier, for those expected to work, typically has a lower tax-back rate, and a higher relative break-even point but a lower guarantee level.

[40] For working age families the level at which social benefits affect work incentives is a function of the wage distribution. When wage inequality in the lower tail of the distribution (e.g. when low-paid workers earn about 40 per cent of the median wage) a high guarantee level will have more disincentive effects than when wage inequality is more modest (e.g. where low-paid workers earn about 70 per cent of the median).

Table 5.4 The cost of eliminating old age poverty, National Accounts estimate, 1990s

Country (year)	Number of poor HH's with old people (thousands)	Poverty gap (local currency)	Extra cost as per cent of GDP
Canada (1994)	118	1591	0.025
US (1997)	5565.9	2931	0.201
Finland (1995)	21.7	3708	0.015
Norway (1995)	60.6	6612	0.043
Sweden (1995)	27.2	10524	0.017
Netherlands (1991)	36.9	5312	0.036
Germany (1989)	633.8	3617	0.080
France (1994)	664.1	8083	0.073

Notes: Extra cost as % of GDP = #poor households × poverty gap)/GDP. Estimates are based on the objective of bringing families containing persons 65+ above 50 per cent of the median adjusted disposable income line. This exercise ignores the fact that this, in itself, will alter the overall distribution and, thus, also the median.

Source: LIS Databases and OECD National Accounts.

savings behaviour but this is likely to occur over a short time period, relatively late in the work career, when the impact of more or less savings on retirement income is known.

Building or enhancing generous basic security schemes with a minimum guarantee above the poverty line goes a long way towards addressing the multiple dilemmas facing pension reform outlined earlier. It establishes a floor beyond which the most disadvantaged pensioners bear *none* of the additional costs of population ageing and so meets at least a minimal requirement of intragenerational justice. Since a guaranteed annual income or minimum pension involves interpersonal redistribution, there is a strong case for general revenue (from income, consumption and other taxes) rather than payroll taxes as the source of financing. Payroll taxes impose all of the cost on the working age population with perverse distributional effects within that population. A large or rising share of general revenue financing provides a powerful tool for reallocating the costs of population ageing based on ability to pay among the retired as well as the working age population since, like the young, the old are also subject to income and consumption taxes.

The cost of eliminating poverty among the elderly will be higher in nations with higher earnings inequality over the working life since there will be more

retirees who are eligible for such benefits. One might think of these additional costs as an 'inequality tax.' the cost of which must be calculated on the basis of one's prior assumptions concerning the effects of wage inequality during the working life on employment and labour market flexibility.

The modern institution of retirement, however, rests on much more than a promise that retirees will not fall into 'poverty'. Post-war retirement patterns reflect the development of institutions that promised much more, namely that the majority would be able to maintain living standards not unlike those reached during their working years.

All of this suggests that the main challenge raised by reduced public or mandatory benefits, in the presence of an adequate basic security scheme, is the probable impact on workers with average and below average earnings who under current provisions would have retirement incomes well above the guaranteed minimum. The challenge, moreover, is not gender neutral. The distribution of income security 'losses' that can result from lower public pensions will have a greater impact on women since they typically have lower lifetime earnings and longer life expectancies than men.

Rationalizing redistribution in earnings-related schemes

Although earnings-related pension schemes ostensibly reflect individual work histories and contributions, all systems have traditionally incorporated design features that produce significant interpersonal transfers and cross-subsidies. During the nineties, eliminating transfers and cross-subsidies that could be identified as 'inequitable,' 'perverse' or 'out-dated,' (such as special privileges for public employees) provided many countries with an effective means of cost reduction. At the same time, however, it was also common to use some share of the savings to create new interpersonal transfers for risk groups now considered to have legitimate claims. This 'rationalization' of redistributive design features to achieve equity or to more clearly realize socially desirable distributive outcomes offers policy makers a potent tool for solving the Rawlsian problem among the non-poor.

For example, Italian and Swedish reforms of the 1990s eliminated transfers that result from the use of final (or best) earnings formulas. As the OECD (1988: 68) points out, final earnings formulas tend to be biased in favour of higher income groups who have steeper age–wage profiles whereas the age–wage profile of lower-income groups tends to be hump shaped or at least to flatten out sooner in the work career. Swedish pensions were traditionally calculated on the best fifteen years. In Italy, the earnings record was based on the last five years for private sector workers and the *last year* for public sector workers. Both nations modified their formulas so that, in future, benefits will

Table 5.5 Change in assessed earnings in final/highest earnings plans

Country	1986	1997
Austria	10	15
France	10	25
Italy	5	Career
Norway	20	20
Spain	8	8
Sweden	15	Career

Sources: OECD, *Reforming Public Pensions*, Paris, 1988; Social Security Administration, *Social Security Around the World, 1986/1997*, Washington: Office of Research and Evaluation, 1986/1997.

reflect average earnings over the entire working life. Other countries with final or best earnings models are also moving in this direction (Table 5.5).

The implications of other changes are more ambiguous since they involve greater *targeting* of interpersonal transfers rather than their elimination. Adjusting the contribution period to compensate workers for irregular work histories is one method many countries have used in the past, provisions that typically benefit women. Rather than basing benefits on a work history of say forty years, Swedish workers were eligible for maximum pensions after only thirty years of contributions. Italian workers were able to claim a pension based purely on years of service (thirty-five years for private sector workers and twenty years for public sector workers) allowing many to retire on a full pension in their early fifties (the so-called 'baby pensioners'). This created markedly different 'rates of return' (and implicit transfers) based on age of labour market entry and employment sector. In both countries, the reforms reduced these transfers by basing benefits on total lifetime contributions.

The reforms, however, did not *eliminate* protection against irregular work histories; rather, social protection against irregular work careers was *targeted* on specific forms of labour market exit typically associated with child and elder care or spells of unemployment (insurable risks). In the new design women (and men) will be compensated for shorter work histories that result from 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 are not insured.

The 1995 Swiss reform is especially striking since the reform was about introducing gender equality and subject to a national referendum (Bonoli, 1997). As in the US, a married man with a dependent spouse was eligible for a 'couple pension' corresponding to 150 per cent of his own pension entitlement, a practice that disproportionately benefits higher income families (Meyer, 1996). 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 per cent of the average wage). Compensation is provided for child rearing but, unlike the previous formula, not for providing housekeeping services to a spouse. The result is a cross-subsidy to families with children from those who remain childless.

These examples of the rationalization of redistribution among retirees illustrate a more general strategy for restructuring traditional earnings-related pension schemes in ways that simultaneously enhance intragenerational equity and intragenerational equality. Redesigning contributory plans to eliminate horizontal cross-subsidies that now seem outdated or that benefit the most advantaged has proven to be a potent source of cost reduction. At the same time, the addition of interpersonal transfers that are more adapted to meeting contemporary needs such as child and elder care credits has also been a potent tool for *modernizing* traditional earnings-related schemes to meet the needs of contemporary families. If pursued aggressively, the enlargement of well-targeted interpersonal transfers *inside* contributory earnings-related schemes provides policy makers with a way of offsetting many of the negative distributional consequences that may otherwise arise from pension reform. As importantly, the result is to create a new framework for managing the distributions of costs of population ageing among both the working and retired population by refinancing the welfare state.

Refinancing Retirement Costs: Intragenerational Justice for the Young

On the financing side, application of the fixed relative position principle also implies that a proportional share of the increased retirement costs that result from population ageing will fall on the working age population, i.e. that contributions will rise. Clearly, however, allocating these costs based on a flat-rate tax without deductions for children or other circumstances (i.e. flat-rate payroll taxes) is inconsistent with the notion that these costs should be

of greatest advantage (or the least disadvantage) to the least well off within the working age population.

As Reynaud (1997) points out, however, a major goal of reforms aimed at rationalizing redistribution within earnings-related schemes during the nineties was to make the division between the contributory and 'solidaristic' (redistributive) elements of payroll-based schemes transparent. Drawing a clear separation between the two creates the opportunity to shift financing of the solidaristic elements from payroll taxes to general revenue, relieving pressure on the former and spreading the transition costs of an ageing society to a larger revenue base.

Bonoli's (1997) interviews with party officials and labour leaders in France and Germany provide striking evidence for the self-conscious character of this strategy. In the words of a 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.' Tuchszirer and Vincent (1997) highlight a similar logic underlying the 1995 Toledo pact, an all-party agreement on the framework for reforming the Spanish social security system.

A rising share of general revenue financing in the retirement budget provides a powerful tool for reallocating the costs of population ageing based on ability to pay not only among the working age population but among the retired as well. While retirees are not subject to payroll taxes they do pay income and consumption taxes.[41] Assuming the more affluent in both populations also pay higher taxes, their share of the additional costs associated with demographic change rises proportionately with increases in the share of retirement costs financed from general revenue.

At the same time, increased transparency creates a *political* framework within which redistributive issues can be addressed. In the age of expansion, many of the redistributive features of the income security system, some of them perverse, were often concealed in complex technical provisions. This strategy was often deliberate, guided by the assumption that concealment made redistribution politically easier (Derthick, 1978). Increased transparency, in essence, repoliticizes issues of how much redistribution and for whom. We should not assume from all this that the effects of reform will all be benign. Whether, for example, working women will be winners or losers as

[41] We do not preclude the possibility that there may be significant advantages to a system of 'earmarked' social security contributions so long as such contributions are based on total income and provide for some degree of progressivity, especially in the lower tail of the distribution, and provide adjustments for family size.

a result of raising the contribution period on the one hand while improving child- and eldercare credits on the other depends on both the relative value of the new credits and future patterns of labour force participation. The point, rather, is that this new architecture creates the possibility for political actors to address systematically the redistributive dilemmas created by redesigning traditional pay-as-you-go defined benefit schemes. The outcomes are clearly indeterminate but the indeterminacy reflects the balance of political forces and institutions of political representation rather than the impersonal forces of the market and/or demography.

If pursued aggressively, if only incrementally, the pattern of reform outlined above implies a strategy that potentially alters the traditional social insurance model of old age security dramatically, at least in the long term. On the benefit side, any reductions implied by the FRP principle are partially offset by new or expanded interpersonal transfers for less advantaged retirees. On the contribution side, these additional costs are met not through higher payroll taxes but with general revenue financing raised among both the retired and the non-retired based on ability to pay. The implication on the benefit side is that with time the earnings replacement function of public sector insurance schemes diminishes somewhat for higher income families (which may be taken up by second and third tier savings).[42] And, with time, the share of general revenue financing for the income security system as a whole rises. The exact mix at the 'end' of the process will vary from country to country since we assume a wide variety of initial starting points and that the strategy is applied incrementally only to the allocation of the *change* in retirement costs that results from population ageing.

Pension reform, the gender contract, and caring work

The issues related to gender equality and gender equity go well beyond those related to the allocation of increased retirement costs due to population ageing that have concerned us here. They are primarily issues of enhancing gender equality over the working life and providing compensating differentials for the uneven distribution of caring work between the sexes, issues that arise even in the absence of population ageing. As we emphasize above, however, they are issues whose broader economic and social importance rise dramatically as a result of population ageing. We have already alluded to the importance of achieving high levels of female employment in an ageing society. The challenges this poses for childcare have been addressed in

[42] We hasten to add, however, that there is no intrinsic reason why second tier employer pensions cannot incorporate interpersonal transfers to achieve desirable social objectives.

Chapters 2 and 3. In this concluding section, we turn to the related issue of eldercare, a task that is rising exponentially in ageing societies, and one that has long been the preserve of daughters, daughters-in-law and ageing wives.

Population ageing has brought this issue to the forefront for two reasons. First, the fraction of the elderly most at risk, the 'oldest old' (80+) has been growing much faster than the elderly population in general. Second, the capacity of the traditional pool of informal care givers (elderly wives, daughters, and daughters-in-law) who provide about three-quarters of all care to the frail elderly (OECD, 1996: 63) is declining relative to this increased demand. Increased longevity means that the care provided by spouses to one another (typically by the wife) occurs at an age when care giving capacity is diminished. Declining fertility has meant fewer non-elderly, typically female, relatives to provide support and they are more likely now to be employed. Our aim here is not to provide a systematic overview of the policy issues related to the provision of home services and long term care for the frail and disabled elderly but rather to highlight important parallels with our discussion of family and pension policy.

Like longevity, the onset and duration of frailty in old age is unpredictable and hence an insurable risk for which at this point in time there is little or no market. The emergent market for long-term care insurance in the US is beset with a variety of problems and still modest in scope (OECD, 1996: 39–40) reminiscent of the world before the spread of mandatory public pensions.

As recent historiography (Haber and Gratton, 1994) has shown, in the world before mandatory pensions, intense poverty in old age was still the exception, mainly associated with those elderly persons without working adult children able or willing to supplement the declining incomes of their ageing parents. Mandatory public pensions, in this sense, were a form of risk sharing not only against the risk of one's own longevity (i.e. for the elderly) but also against the risk of one's parent's longevity (i.e. for their working age children) and the imperative of supporting parents financially through an extended old age. Similarly, the expansion of publicly financed long-term care and home help services in the contemporary period represents a welfare gain not only for the frail elderly who receive these services but also for their adult children and other family members who otherwise must provide such services directly.

As with childcare, eldercare still remains largely women's work and much of our discussion of the former can be applied to the latter with little modification, a fact implicitly recognized by countries that now provide elder- as well as childcare credits in their pension formulas. Achieving gender equality requires attention to the caring work women provide to those at both ends of the life course.

Conclusion

Population ageing is not new. Western societies have been growing 'older' for well over a century. Those of us now living grew up in a world with many more elderly parents and grandparents than any previous generation and our children and grandchildren will grow up with even more older persons. There has been enormous variation in the quality of life over the twentieth century but these variations have had little to do with changes in population age structure.

In contrast, modern 'retirement', an extended period of labour force exit driven by wealth, not disability, is new for most people. This change was the result of rising affluence, on the one hand, and, on the other, the post-war pension 'revolution' that expanded access to this new wealth, however unevenly, to the majority of older households. The question then is not whether we will survive 'population ageing' (we will). Rather, in face of an impending acceleration in the rate of population ageing, the big questions concern whether and in what form modern retirement will survive, at what cost, and to whom? Of particular concern is whether the fiscal pressures (i.e. on the public budget) that result from population ageing will erode the democratic gains in equalizing access to retirement achieved during the post-war era of pension reform.

We have little doubt that an extended period of retirement will continue to be the normal conclusion to the economic life course for the affluent, especially for affluent two-earner couples. Because the less affluent depend much more on public pension and other services (such as health care), the political risk associated with population ageing is that public sector reforms could lead to greater inequality in access to retirement and preclude the possibility of a still fuller democratization (e.g. between men and women) of retirement opportunities.

How, then, to respond? The combination of a strong basic security programme and appropriately designed cross-subsidies in earnings-related programmes provide potent tools for addressing issues of intragenerational justice among the elderly and for democratizing pension entitlements among men and women. Both strategies produce a changing mix of revenue sources and benefits that makes it possible to allocate costs based on the ability to pay among both retirees and workers.

The traditional pay-as-you-go model is useful for illustrating the intergenerational dilemma posed by population ageing. The usual defined benefit formula tends to impose all the costs of population ageing on the working age population, a solution that is inconsistent with the principle of

intergenerational equity. But shifting to a model based on fixed contribution rates is equally unacceptable. As an alternative, we have advocated Musgrave's 'fixed relative position' solution in which the ratio of per capita earnings (net of contributions) and (net) benefits are set so as to hold constant the ratio of the two. The advantages are several. It provides for a fair sharing of risks with regard to both population and productivity change and obviates the need for planning now based on uncertain and risky projections of the future. Since actual outcomes are unpredictable, the main requirement of any new pension design is that it provides future generations with sufficient flexibility to adjust to the changing circumstances of both the old and the young.

Implementation of such a strategy in the real world where the consumption of the retired is financed from a variety of sources is, of course, decidedly more complex. Paradoxically, however, nations where the public sector share of retirement costs is larger probably have had an historical advantage with respect to facing up to these issues. The maturation of public pension schemes since the 1970s combined with adverse economic conditions compelled these nations to address the fundamental issues of retirement costs well in advance of the demographic shift all nations will experience in the next quarter century. Many of the lessons to be learned from efforts to reform the large public pay-as-you-go systems have already been acquired. The trade-offs and dilemmas are known and there is some experience in addressing these problems. For countries where there is greater reliance on advance funded employer schemes and tax-subsidized personal retirement accounts, the challenges of achieving social objectives related to intergenerational justice and intragenerational fairness will require a sea change in the policy tools and accounting methods used to measure the distributional consequences of alternative strategies. A larger private sector does not imply that markets are in charge, only that the strategies differ: a fair and just cost allocation of retirement costs depends more on regulation and taxation policies when the private sector role is greater.

Maximizing employment among the working age population and raising actual retirement ages among older workers, particularly in countries where employment levels (Table 5.1 above) are very low, provides one of the most potent tools for containing the growth in retirement costs but potentially one of the more difficult to implement. Healthier and better educated older workers are capable of working longer but are unlikely to do so in the absence of healthier and better workplaces.

If we have focused on the distributive challenges generated by population ageing, we have not exhausted the subject. Perhaps the single greatest 'silence' in all recent discussions of these issues concerns the potentially huge

impacts of the underlying demographics on the intergenerational transmission wealth both through inheritance and through transfers between older parents and their adult children prior to death.[43] Changes in fertility combined with rising female labour force participation are undoubtedly creating an enormous intergenerational funnel for transmitting wealth across the generations about which we know little and understand less. Although working out the implications is difficult, the arithmetic for the intuition is easy. The demographic shift from three- or four-child families to one- and two-child families *combined* with the dual-earner household is creating it's own set of winners and losers *within* the next generation and those that follow. *Within* generations, children from wealthy families and few siblings stand to be the winners in the intergenerational lottery. The 'lottery' has of course always been present but population ageing and new family forms have raised the stakes. For the 'lucky' few, or perhaps many, the 'retirement' decision in the future—when to work and how much—will possibly depend less on their own work careers and more on the work careers (and longevity) of their parents. If so, the problem of 'class' and intergenerational inheritance will be magnified at the end of the life course as well as at the beginning.

[43] In particular, the usual discussions of 'intergenerational accounting' that focus only taxes and transfers has nothing to say on this topic.

6

The Self-Transformation of the European Social Model(s)

Anton Hemerijck

The European Social Model

European welfare states are in varying need of reform. Intensified international competition, ageing populations, de-industrialization, changing gender roles in labour markets and households, and the introduction of new technologies, all pose severe strains to welfare state programmes designed for a previous era. Identifying new social objectives with no regard to their practical political relevance and implementation within diverse European welfare models, would remain a sterile academic exercise. For this reason the analytical focus in this final chapter shifts from the 'problem-oriented' question: 'What sort of new welfare architecture is required in the face of the strains of transformation?', to the 'political-institutional' question: 'What kinds of policies are feasible and fair, given the tremendous differences in welfare state design and in decision making structures across Europe?'

All European welfare states share three distinctive characteristics. Normatively, there is a common commitment to social justice. The vocabulary of reform in most Member States is couched in terms of a solidaristic commitment that society will not abandon those who fail. The preference for minimum guaranteed resources is widely accepted by European publics and deeply entrenched in policy programmes and institutions. The stigmatizing discourse of the 'deserving' versus 'undeserving' poor never really gained currency in the European Union, apart from the Thatcher era in the United Kingdom in the 1980s (Schmidt, 2000).

At the cognitive level, the European social model is based on the recognition that social justice can contribute to economic efficiency and progress. As a 'beneficial constraint', a term coined by Wolfgang Streeck, social policy can reduce uncertainty, enhance the capacity to adjust and the readiness to

Article

Beyond privatization: pension reform in the Czech Republic and Slovenia

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Summary Research on the political economy of pension reform has focused on the recent wave of pension privatizations in the post-socialist region. This paper is motivated by the need to shed more light on cases where radical reform was rejected. Pension privatization did not proceed when the World Bank and the Ministry of Finance – important advocates of radical reform – were absent from the pension reform arena and the Ministry of Social Affairs was the only relevant reform actor. Moreover, unions need not be secondary actors, but may effectively veto pension privatization. The paper highlights the importance of the specific political and economic conditions that may constrain the leeway of pension reform actors, while also discussing the global politics of attention.

Key words pension reform, political economy, transition countries

Résumé La recherche sur l'économie politique de la réforme des pensions s'est focalisée sur la vague récente des privatisations des pensions dans la région post-socialiste. Cet article s'attache à examiner les situations dans lesquelles une réforme radicale a été rejetée.

La privation des pensions n'a pu être réalisée là où la Banque Mondiale et le Ministère des Finances – tous deux avocats de réformes radicales – furent absents des débats et lorsque le Ministre des Affaires Sociales constituaient le seul acteur pertinent de la réforme. En outre, les syndicats ne restent pas des acteurs de second plan. Ils peuvent y mettre leur veto.

Tout en soulignant l'importance de conditions politiques et économiques données qui contraignent les prises de positions des différents acteurs, cet article examine également de manière plus large le rôle des institutions internationales et des agendas.

Introduction

In the past decade, many countries in Central and Eastern Europe (CEE) and the former Soviet Union (FSU) witnessed not only a fundamental transformation of their societies and economies, but also of their retirement schemes. Contrary to the conventional claim that pay-as-you-go (PAYG) schemes are 'highly resistant to radical reform' (Pierson, 2001: 416), in some post-socialist countries mandatory privately funded schemes were established, while the public PAYG schemes were downsized or closed. Between 1998 and 2002, a full or partial shift to funding was carried out in Kazakhstan, Hungary, Poland, Latvia, Bulgaria, Croatia and Estonia, while other countries in the region are currently preparing similar reforms.

Such a move is radical because it implies a fundamental paradigmatic departure from the previous pension system: from collective to individual provision for old age, as well as from the state to the market as the main supplier of retirement pensions. The 'paradigm shift' (Holzmann, 1997: 6) inherent in radical

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Journal of European Social Policy 0958-9287 (200211)12:4 Copyright © 2002 SAGE Publications, London, Thousand Oaks and New Delhi, Vol 12 (4): 293–306; 028430

pension reform therefore amounts to a substantial rewrite of the underlying social contract, which does not usually occur in the case of a mere change of the entitlement conditions. Recent research on pension reform in the post-socialist region has mostly sought to explain these 'unlikely' cases of pension privatization, that coincide with the emergence of a 'new pension orthodoxy' advocating the privatization of old-age security, particularly in developing and transition countries (Lo Vuolo, 1996; Müller, 2002b).[1]

Yet, in CEE and the FSU most countries still rely on their public PAYG scheme as the only provider of mandatory old-age insurance (Fultz and Ruck, 2000; Müller, forthcoming). Ultimately, the political economy of pension reform will need to address the full range of policy choices. It is to broaden the scope of this newly emerging strand of research that this paper discusses the cases of the Czech Republic and Slovenia. Today, after a series of parametric reforms, the pension system in both countries is essentially two-tiered, combining a public mandatory PAYG scheme with a supplementary funded tier. While the second tier[2] in the Czech Republic consists of a voluntary private scheme offering personal pension plans, there are three supplementary pension schemes in Slovenia: a voluntary private scheme that can take the form of occupational schemes or personal pension plans, as well as a mandatory scheme for the formerly privileged branches and a pension fund for privatization certificates, both run by the state-owned *Kapitalska druzba*. Unlike in other post-socialist states, there has been no shift to funding at the expense of the public pension tier in either country.

The paper seeks to come up with a comparative explanation of the paradigm choice of policymakers in the Czech Republic and Slovenia. Their decision against the policy recommendations of the new pension orthodoxy and in favour of a more moderate approach to pension reform is interpreted as a result of the interplay of economic and political variables. These two cases are discussed in the context of the existing body of knowledge on the politics of pension privatization (see, e.g., Müller, 2002b). The analysis is largely based on literature addressing the political economy of policy reform published over the past decade.[3] The heuristics is inspired by actor-centred institutionalism, a methodology that seeks to overcome the 'classical' schism within the social sciences (Mayntz and Scharpf, 1995; Scharpf, 1997).

Explaining pension reform: foreign influence, local actors and the policy context

The new pension orthodoxy

In many Latin American and East European countries, the public–private mix in mandatory provision for old age has been changed significantly over the past decade. The recent adoption of similar pension reform blueprints across countries and regions suggests that a common international transmission mechanism of ideas is at work. And indeed, a dominant epistemic community[4] can clearly be identified that has been giving major impulses to pension privatization, arguing that such paradigm change in old-age security would lead to both a rise in saving and to efficiency improvements on financial and labour markets, thereby resulting in an increase in long-term growth (Corsetti and Schmidt-Hebbel, 1997).

Conservative critics of the welfare state had long prepared the ground for a paradigm change in old-age security, as described in Hirschman (1991). It was in the wake of the end of the Cold War that the terms of the prevailing discourse in old-age protection shifted, interacting with the rise of neo-liberalism as the dominant paradigm in economic policy making, particularly in developing and transition countries. While originally not contained in the so-called 'Washington Consensus' (Williamson, 1990), pension privatization has long become part and parcel of the neo-liberal reform package. In Eastern Europe, this paradigm shift coincided with the first post-socialist years, marked by a widespread move towards the market in economic policy.

An increasing amount of contemporary policy change is affected by policy transfer and the global diffusion of models (Dolowitz and Marsh, 2000; Weyland, 2001). Radical agenda shifting in old-age security reform was frequently connected to World Bank involvement. In 1994, the Bank's research report on pension policy attracted global attention and has since turned into the best-known example of what has become the new pension orthodoxy.[5] Apart from the ubiquitous conditionalities, channels to support pension privatization include loans and an expert-based knowledge transfer – a potentially attractive assistance package for local policymakers. In recent years other international financial institutions and government agencies – such as the International Monetary Fund (IMF) and the US Agency for International Development (USAID) – have followed suit. Although they have taken part in joint conditionalities for pensions-related financial assistance with the Bank, as well as other forms of cooperation, overall they play a less outstanding role.

The pension reform arena: actors and constraints

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

Scholars of the political economy of policy reform have stressed the importance of political leadership – courageous, committed individuals, often market-oriented economists – and their ability to communicate a coherent neo-liberal vision (Harberger, 1993; Sachs, 1994). It has been shown elsewhere that pension privatization amounts to a paradigm shift that may be greatly facilitated by such committed policymakers. However, the existence of these agenda-setters can certainly not be considered sufficient to guarantee success against powerful interest groups (Williamson and Haggard, 1994; Tommasi and Velasco, 1996).

Radical paradigm change in old-age security was usually advocated by the Ministry of Finance, staffed with neo-liberally trained economists. This portfolio, together with the Ministry of Economic Affairs and the Central Bank, felt that pension privatization perfectly matched their overall efforts to decrease the role of the state in the economy. These local advocates of a globally propagated agenda were supported both by local interest groups, such as business organizations and the financial sector, and the international financial institutions. But there was also opposition to these radical plans, both within and outside government. More often than not, the Ministries of Labour, Welfare or Health, responsible for the existing old-age security schemes, were reluctant to engage in structural pension reform, thus reflecting the existing Bismarckian traditions in Eastern Europe. In several countries, these ministries initially objected to the radical paradigm shift, but – given the predominance of the Finance Ministry in the Cabinet – proved too weak to prevent it (Müller, 1999; Nelson, 2001). Other local opponents of pension privatization included trade unions, social security employees, and – last but not least – pensioners' associations and special-interest groups with privileged pension schemes. In several countries, left-wing parties also joined the ranks of opponents.

Which of these pension-reform actors gain room for manœuvre in a local pension reform

arena largely depends on the prevailing political and economic conditions that operate as contextual constraints. Clearly, the specific policy context may provide reformers or reform opponents with action resources (Kay, 1999). The executive's degree of control over the legislature amounts to a pivotal institutional variable. Veto points, built into the political system, provide a particular group with strategic opportunities and potential political impact (Immergut, 1992). In some countries trade unions had traditional ties with the governing parties that were used to ease resistance. Yet these ties also implied that reform opponents were in a political position that forced pension reformers to negotiate and to make concessions, most notably granting trade unions the right to run their own pension funds (Isuani and San Martino, 1995; Orenstein, 2000).

Economic factors and considerations appear to have had a substantial impact on the choice of reform model. As noted above, pension privatization has been primarily proposed for macro-economic motives, seeking to embark on a virtuous circle leading to economic growth. Madrid (1998) and James and Brooks (2001) have pointed to increased international capital mobility and the recent experiences of capital market crises, that may have induced policymakers to seek to reduce the vulnerability to capital outflows by boosting domestic savings and the local capital market.[6] Moreover, scholars of the political economy of policy reform have highlighted that a preceding crisis may induce radical change – the so-called 'benefit of crises' hypothesis (Drazen and Grilli, 1993).[7] Fiscal crises turn the Ministry of Finance into a potential actor in the pension reform arena. More specifically, when pension finances display a deficit, the resulting dependence on budgetary subsidies grants this likely advocate of the new pension orthodoxy an important stake in reforming old-age security (Müller, 1999). Furthermore, a persistent financial crisis may severely erode public confidence in the public pension systems, thus facilitating fundamental reform.

Yet another economic factor had an impact: when external debt is high, governments tend to stress their general commitment to market-oriented reform. In this context, the announcement of pension privatization can be interpreted as a 'signalling' strategy (cf. Rodrik, 1998). And indeed, by the mid-1990s, rating agencies had included radical pension reform as a point in favour in their country-risk assessments. Critical indebtedness also increases the likelihood of the involvement of international financial institutions in the local pension reform arena (Brooks, 1998). Their leverage is partially determined by their stakes as important creditors in many transition countries. However, their impact is not limited to binding conditionalities resulting from their own financial involvement. Rather, it is the general level of external indebtedness that matters, as the IMF and the World Bank 'may signal that a developing country has embraced sound policies and hence boost its credibility' (Stiglitz, 1998: 27). When their recommendations are disregarded by local governments, alternative sources of market financing are often hard to obtain. As noted by Kay (1999), policymakers were well aware that financial and/or technical support from the international financial institutions was only available for a pension reform that included a privatization component.

Earlier scholarship on welfare state development has stressed the importance of existing institutional arrangements for future reform paths – policy feedback or path dependence.[8] 'Existing policies can set the agenda for change . . . by narrowing the range of feasible alternatives' (Pierson and Weaver, 1993: 146). Frequently, the success of reform strategies depends on earlier policy choices and the policy feedback resulting from them. In Bismarckian-style PAYG schemes, lock-in effects and opportunity costs may result from the pension rights earned by the insured, engendering high transition costs. The size of these entitlements, frequently called 'implicit pension debt', is determined by the percentage of the population covered, the maturity of the scheme and the generosity of benefits. When made explicit, these implicit liabilities translate into high fiscal costs. It has therefore been argued that the larger the implicit pension debt, the smaller the likelihood of the most radical structural pension reform (James and Brooks, 2001).

The dismissal of pension privatization in the Czech Republic and Slovenia

The Czech case

Until the mid-1990s, the basic conflict surrounding pension reform in the Czech Republic had been about the scope of parametric reform. In 1995, the Klaus Government obtained parliamentary approval for a very controversial Pension Insurance Act that introduced a two-part pension formula and raised the retirement age. The year before, a law establishing supplementary private pension funds had been approved (see Appendix Tables 1 and 2). Advocates of full or partial pension privatization made themselves heard shortly afterwards: young Czech economists connected with the international orthodoxy – 'market komsomols' in local jargon – had joined forces with the stakeholders from the financial community and the liberal Union of Freedom to place a shift to funding on the political agenda. However, these efforts at agenda shifting did not succeed in having an impact on the government's reform strategy.[9] After simulating the overall impact and costs related to a partial privatization of the Czech pension scheme, as against the alternative, a thorough reform of the existing PAYG scheme, the experts at the Ministry of Labour concluded that there was still sufficient leeway within the existing public PAYG system to face the challenges of the next decades (Mácha, 2002).

The World Bank, the main transmitter of the new pension orthodoxy, could have reinforced the local privatization faction with its global experience in promoting and assisting pension privatization, yet it was absent from the Czech reform arena. The Bank's lack of leverage in the Czech Republic coincides with a low level of external debt (World Bank, 2001b). For almost a decade now, the only portfolio involved in the Czech pension reform efforts has been the Ministry of Labour and Social Affairs, traditionally inclined towards Bismarckian and Beveridgean paradigms. As the public pension scheme was financially viable without any subsidies from the general budget until 1997, the Ministry of Finance, a potential intra-governmental advocate of pension privatization, had no stake in pension reform. However, the Czech pension scheme has been in the red for six years now, and successive finance ministers have still remained passive. On the one hand, a possible explanation is related to the fact that pension privatization implies substantial fiscal costs in the short and medium run. On the other hand, the severe economic and financial crisis that hit the Czech Republic in 1997 should be recalled. While uncovering the still shaky bases of the local capital market, the introduction of a mandatory funded tier was deemed particularly inappropriate. Owing to the substantial costs of bank bail-outs, the financial-sector crisis also translated into a fiscal burden (World Bank, 2001a), thereby contributing to a narrowing of the budgetary scope for pension privatization.

The Czech trade unions, another relevant political actor, used to be fiercely critical of the parametric reforms envisaged by the Klaus Government. This became particularly manifest during the conflicts surrounding the 1995 Pension Insurance Act. Even if they were in no position to veto this law, their opposition raised public awareness about the unpopular retrenchment measures and contributed substantially to the electoral defeat of the ruling coalition in 1996. When pension privatization appeared on the Czech agenda, they changed their stance: instead of pushing for the maintenance of the status quo, they now claim that the existing options to reform the public

PAYG scheme have not yet been exhausted in the Czech Republic, opposing a full or partial shift to funding. Given the vociferous role that the unions have played in the past, policymakers are likely to take them into account, in spite of the absence of strong corporatist decision-making structures in the Czech Republic (Casale, 1999). Politically, their campaigns translated into support for the Social Democrats and the Pensioners' Party, with the latter single-issue party failing to enter Parliament (Müller, 1999).

This country's paradigm choice beyond the dominant international mainstream might appear particularly surprising, given the neoliberal discourse of the long-standing Czech Prime Minister, Václav Klaus – seemingly an excellent ideational match for the new pension orthodoxy. However, his favourite pension reform path involved very low replacement rates in the public tier, to create incentives for Czechs to join the supplementary tier voluntarily. In this sense, he may be considered 'too liberal' for the orthodox template. Moreover, Klaus's general reluctance towards foreign advisors and the international financial institutions in particular were notorious (Blejer and Coricelli, 1995). Finally, it should also be remembered that since 1996 – i.e. the very moment when the Poles and Hungarians started preparing their partial pension privatizations – Czech governments could not count on a parliamentary majority. In addition, the incoming Social Democrats, traditionally oriented towards Bismarckian and Beveridgean-type approaches, opposed pension privatization, together with their main political ally, the trade unions. Public support for such a paradigm shift was also minimal (Vecerník and Mateju, 1999: 201). In recent years the executive's control of the legislature has been so limited that the government's plans for a substantial parametric reform have not been politically feasible either, thus only increasing their urgency. With elections due in 2002, it is likely to be the next government that will determine the future of the Czech PAYG scheme.

The Slovene case

In Slovenia, two major legislative efforts to fix the PAYG system stand out – the Pension and Disability Insurance Acts of 1992 and 1999. While the former mainly introduced stricter eligibility rules, a reaction to soaring pension expenditures, the 1999 act launched a system of penalties and bonuses for early and delayed retirement, increased the pensionable age for women, decreased accrual rates, further tightened eligibility and introduced supplementary funded tiers (see Appendix Tables 1 and 2). It was in the mid-1990s, between both legislative efforts, that the new orthodox template appeared in the Slovene pension reform arena (Stanovnik, 2002). The relevant agenda-shifters in the local pension reform debate appear to have been the IMF and the World Bank. During an expert mission to Slovenia in 1995, they emphasized the need for more fundamental reforms in the public pension scheme and also proposed the introduction of a multipillar scheme. Subsequently, the World Bank sought to support pension privatization in Slovenia by means of an earmarked loan, co-sponsoring an international pension conference in October 1997 and a workshop on second-pillar issues in March 1998, both in Ljubljana, as well as trips to Switzerland and the Netherlands for first-hand experiences with multipillar schemes.

As regards local actors, the push towards a multipillar-type reform came from Tone Rop, a leading figure in the LDS – the centre-left party dominating Slovene politics since independence – and clearly one of the most influential individual policymakers in Slovenia. When he took over the Ministry of Labour after the resignation of his social-democratic predecessor in 1996, pension reform became the economist's top priority. The initial policy document – elaborated with significant input by Milan Vodopivec, a former World Bank official – strongly advocated partial pension privatization. The subsequent White Paper on Pension Reform was co-authored by a team of Phare consultants, among them a leading ILO specialist. These French and Italian social security experts took a more cautious stance on the proposed mandatory second tier, notably with regard to its fiscal implications, a concern corroborated by simulation exercises. However, the final version of the White Paper, published in November 1997, still included pension privatization.

When the White Paper was discussed with social partners in a working group in January 1998, the Slovene trade unions used this pivotal chance to veto pension privatization irrevocably. The existence of formal tripartite structures – the Economic and Social Council, a de facto veto point in Slovene legislation – allowed them to play a significant role in pensions-related decision making. Moreover, the unions held several large rallies against some of the envisaged parametric reforms and the introduction of a mandatory second tier. Another ally within the 'grey lobby' and a member of the governing coalition during the pension reform process, the Pensioners' Party, also declared its opposition. Moreover, criticism against the government's plan to partially privatize old-age security was raised by some well-known social security experts with a background in economics and law. One of the most influential Slovene economists, Velimir Bole, highlighted the substantial fiscal costs of the proposed multipillar scheme in a paper commissioned by the World Bank. At this point, the Minister of Finance, Mitja Gaspari, publicly declared that a mandatory second tier would not be fiscally feasible.[10] Subsequently, Tone Rop gave up on pension privatization. At a Cabinet meeting four weeks later, the pension reform course was quietly changed. The draft law on pension and disability insurance, approved by the Slovene government in June 1998, proposed a reform of the public PAYG scheme in combination with the introduction of a voluntary funded tier. After lengthy negotiations within the ruling coalition and with social partners, this law was passed in December 1999. With a rather broad political alliance governing Slovenia from 1997 to 2000, policy making was characterized by the search for consensus rather than by the rapid enforcement of radical structural reforms.

A comparative discussion of policy choices

The pension policy pursued in the Czech Republic and Slovenia can be interpreted as a move towards the Continental European mainstream in old-age security[11] and as a conscious decision against the policy recommendations of the new pension orthodoxy. It should be noted that in Slovenia it is widely felt that pension reform has been completed with the 1999 reform, yet the opposite is true in the Czech Republic: while virtually all policymakers agree that further reform steps are indispensable, no political consensus has yet been achieved on their nature. The obstacles to parametric pension reform in the Czech Republic highlight the fact that such reforms have considerable potential to generate blame. They allow the easy identification of individual losses and are perceived as a mere cutback of acquired entitlements without anything being offered in exchange (Holzmann, 1994; Müller, 1999). Therefore, Czech and Slovene policymakers resorted to strategies of obfuscation, compensation and bundling to reduce political opposition to their retrenchment policies (Mácha, 2002; Stanovnik, 2002). In the following part of this paper, the actor-related and structural-institutional factors accounting for the absence of radical pension reform in both transition countries will be identified.

Whereas Ministries of Welfare are traditionally inclined towards the Bismarckian and Beveridgean paradigms and Ministries of Finance have tended to join the ranks of the new pension orthodoxy in many countries, these ideational distinctions proved to be less clear-cut in the two countries analysed here. The unusual degree of mobility between both of these crucial portfolios only indicates that it is harder to attach a specific policy preference to either ministry in the above country cases:

in Slovenia, Tone Rop – the principal advocate of the proposal to partially privatize old-age security – was appointed Minister of Labour after having worked as State Secretary of Privatization and before becoming Minister of Finance. In the Czech Republic, Jirí Rusnok, a former advisor to the trade union federation, was recently appointed Minister of Finance after having served as Deputy Minister of Labour (Mácha, 2002; Stanovnik, 2002).

It is this context that sheds light on the unusual fact that the Slovene Minister of Labour was the main driving force behind the preparations for partial pension privatization, and that it was the Minister of Finance who vetoed it. While the essence of the latter is a well-known mechanism, stemming from the relative weight of both portfolios in Cabinet, it is at odds with the pattern of several recent pension reforms in Eastern Europe. Most notably, the policy implications are reversed, as pension privatization was effectively stopped. Contrary to this, in the Czech Republic the Ministry of Labour remained in charge of the reform of old-age security, even after fiscal difficulties appeared. Moreover, no prominent policymaker was committed to pension privatization, and it was only during Tosovsky's brief caretaker government that a multipillar scheme was seriously considered. In the midst of political and economic crisis, this was also the only moment when the Czech Ministry of Finance abandoned its passive role, that had first been induced by the pension scheme's surplus and then by concerns regarding high transition costs.

The cases of the Czech Republic and Slovenia show that there is a flip side to the economic factors and considerations that potently pushed pension privatization elsewhere. In both countries, policymakers were fully aware that pension privatization would have resulted in substantial fiscal costs in the short and medium run, thus complicating future compliance with the Maastricht commitment to budgetary discipline in the eurozone. Particularly in a context of high implicit pension debt, as in Slovenia and the Czech Republic, this concern may render finance ministers potentially ambivalent allies of the new pension orthodoxy. Moreover, while the development of the local capital market was a frequently mentioned motive for pension privatization elsewhere, policymakers in the two countries reviewed here explicitly pointed to the nascent stage of Slovenia's capital market and the crisis-ridden financial sector in the Czech Republic when cautioning against radical pension privatization. It should be noted that perceiving poor capital market development as a constraint to the introduction of a mandatory funded tier is rare among post-socialist pension reformers. The public's deep-rooted mistrust of the existing financial institutions also limited the scope of individually fully-funded old-age provision (Vecerník, forthcoming). Instead of perceiving this as a case for mandating a second tier, Czech and Slovene policymakers decided to give employers more room in the supplementary private schemes.

Trade unions and pensioners' parties had an important role to play in both pension reforms. While this 'grey lobby' strongly resisted parametric changes to the existing PAYG schemes in many transition countries, in the Czech Republic and Slovenia plans to reform old-age security triggered the largest political rallies since independence. The Pensioners' Party failed to enter Parliament in the Czech Republic, yet in Slovenia it even formed part of the governing coalition at the time of the 1999 reform. Even though it could count on only five seats in Parliament, its interests had to be balanced against other policy preferences. In the post-socialist world, the trade unions have also been dubbed 'pensioners' parties' since many of their members are retired. It is interesting to note that neither the Czech nor the Slovene unions were interested in reaping economic benefits from the setting-up of their own pension fund in a mandatory tier, contrary to a part of organized labour elsewhere (e.g. in Croatia, Bulgaria and Poland, but also in Argentina and Chile). The Slovene unions were in close contact with

their German counterparts, staunch opponents of pension privatization. In the case of the Czech unions, their reluctance may be connected with the fact that their early involvement within the voluntary funded tier remained unsuccessful.

The Czech unions voiced strong opposition to the 1995 pension reform law, but started to advocate parametric reforms when pension privatization appeared on the political agenda. Local decision-making structures fail to grant social partners formal veto opportunities, yet Czech policymakers are certainly not keen to revive the protests of the mid-1990s. Slovene trade unions enjoyed more voice in the pension reform arena than their Czech counterparts. They were invited to discuss subsequent pension-reform proposals in tripartite working groups, expressing their adamant opposition to the privatization of old-age security and contributing significantly to the demise of the multipillar approach in Slovenia. In both the Czech Republic and Slovenia, trade unions were close political allies of the Social Democrats, another important opponent of a mandatory funded pension tier.

Finally, the cases of the Czech Republic and Slovenia highlight the dynamics of a 'global politics of attention' (Orenstein, 2001; Orenstein and Haas, 2002). While international financial institutions – particularly the World Bank – turned into powerful actors in the post-socialist pension reform arena, their leeway as advocates of multipillar schemes is clearly constrained by contextual factors. Slovenia and the Czech Republic are very advanced transition countries, characterized by a low level of external debt (World Bank, 2000; 2001b). In this context, both the potential leverage and the interest of the international financial institutions to spend resources on the promotion of pension privatization is limited. On the eve of EU accession, both countries showed a strong orientation towards the Continental European mainstream, that EU-sponsored programmes like Phare helped to transmit. Notably in Slovenia the Phare team, featuring a long-standing director of the ILO social security department, had a strong impact and helped to shift the balance towards a more critical assessment of funded proposals.

Conclusion

Following the recommendations of the new pension orthodoxy, one out of two post-socialist Accession Candidates to the European Union has embarked on partial pension privatization by now. This wave of iconoclastic reforms triggered several recent studies on the politics of pension privatization in transition countries. Yet, in CEE and the FSU public PAYG schemes for mandatory old-age insurance still feature prominently, and pension privatization is not universally accepted. Hence, there are multiple possible outcomes of pension reform in the post-socialist world awaiting explanation. This study focused on the Czech Republic and Slovenia to shed more light on those cases where radical pension reform was rejected.

In order to be adopted in the local reform arena, the new orthodox template requires both an agent for its transmission, mostly the World Bank, and an influential local actor ready to adopt neo-liberal blueprints, generally the Minister of Finance. Full or partial pension privatization was feasible when these advocates of pension privatization had stakes and leverage in the local reform process, resulting from financial imbalances and a high level of external indebtedness, respectively. By comparison, radical pension reform did not proceed when the Ministry of Social Affairs, often inclined towards Bismarckian and/or Beveridgean traditions, was the only relevant pension-reform actor.

The cases of the Czech Republic and Slovenia confirm most of these basic insights from the expanding contemporary literature on the political economy of pension reform. Most importantly, the World Bank's leeway was curbed by both countries' low indebted-

ness, thus limiting the leverage of the pro-privatization factions in both countries. Moving beyond earlier findings, however, the Czech and Slovene cases highlight that intra-governmental actor constellations in post-socialist pension reform need careful differentiation; i.e. the key ministries – Finance and Social Affairs – may play different roles and have other policy preferences than those predicted in earlier research. In addition, both cases show that trade unions need not be secondary actors in the pension-reform arena, but may effectively veto pension privatization.

Moreover, the Czech and Slovene cases make it clear that the impact of economic factors and considerations on pension-reform choices needs to be contextualized. Sharing a legacy of high implicit pension debt, policy-makers in both advanced transition countries were less inclined to place their hopes in the potential impact of a shift to funding on saving and growth. Rather, they were concerned about the fiscal costs triggered by pension privatization and the risks that forced savings schemes may face in a context of nascent, crisis-ridden capital markets. Overall, these findings indicate that there may be some potential for diversity in post-socialist pension reform after all. Yet, more comparative research is needed to account for the emerging diversity of patterns and actor constellations in post-socialist pension reform.

Acknowledgements

This paper is based on research from a study written for the ILO–CEET Project RER/MO7/FRA 'Strengthening Social Security in Central and Eastern Europe through Research and Technical Co-operation'. It is the result of a joint research effort with Elaine Fultz (Budapest), Martin Mácha (Prague) and Tine Stanovnik (Ljubljana), to whom the author is grateful for valuable discussions and many insights. Helpful suggestions by two anonymous referees and the editors of JESP are gratefully acknowledged. The research study chapter by Katharina Müller that this paper stems from is entitled 'Between State and Market: Czech and Slovene Pension Reform in Comparison' and was prepared for the ILO publication entitled *Pension Reform in Central and Eastern Europe, Volume 2*, copyright © International Labour Organization 2002.

Notes

1 Studies on the political economy of pension privatization in the post-socialist world include Müller (1999), Orenstein (2000) and Nelson (2001). Brooks (1998, 2001), Madrid (1998, 2001), Chlon and Mora (2001), James and Brooks (2001), Müller (2001, 2002b) and Orenstein (2001) seek to provide a cross-regional explanatory framework, that includes the Latin American cases of pension privatization.

2 According to World Bank terminology, this would be a third-pillar scheme (see, e.g., World Bank, 1994).

3 For an overview of the political economy of policy reform see Rodrik (1996), Tommasi and Velasco (1996), Sturzenegger and Tommasi (1998), Drazen (2000) and Krueger (2000).

4 An epistemic community is a network of professionals in a particular domain and with a common policy enterprise, who may come from different professional backgrounds. They share faith in specific truths and in a set of normative and causal beliefs, have shared patterns of reasoning and use shared discursive practices (Adler and Haas, 1992; Haas, 1992).

5 A sizeable 'heterodoxy' remains, however. Mesa-Lago (1996) and Ney (2000) point to conflicting policy prescriptions by international organizations. For the debate between the World Bank and the ILO see Beattie and McGillivray (1995) and James (1996). For a recent critique of the new pension orthodoxy see Barr (2000), Charlton and McKinnon (2001), Orszag and Stiglitz (2001).

6 Yet, contrary to these high hopes, the Chilean evidence suggests that pension privatization actually had a negative impact on national saving (Mesa-Lago, 1998).

7 Situations of perceived emergency can induce contending political groups to agree upon unpopular, painful measures and facilitate the destruction of political coalitions that had blocked reform, breaking a previously existing stalemate (Williamson, 1994). However, the 'benefit of crises' hypothesis has not met with unanimous approval by scholars of the political economy of policy reform.

8 On the concept of policy feedback see Esping-Andersen (1985) and Pierson (1993); for a recent discussion of the concept of path dependence see Pierson (2000).

9 Jacoby (1998: 18) has defined agenda shifting as the power to intervene at critical moments, introducing crucial new models in a policy arena.

10 At this moment, public finances in Slovenia had gone into the red (EBRD, 2001).

11 Admittedly, old-age security schemes in Continental Europe are extremely diverse. Reference to the 'mainstream' denotes a combination of a public mandatory PAYG scheme, inspired by Bismarckian principles, and a supplementary private tier on a voluntary basis.

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Appendix Table 1 Basic features of the reformed public pension schemes in the Czech Republic and Slovenia

Characteristics	*Czech Republic*	*Slovenia*
Type	mandatory, PAYG	mandatory, PAYG
Nominal contribution rate	26.0	24.35
– of which employees	6.5	15.50
– of which employers	19.5	8.85
Contribution ceiling	no	no
Separation of pension fund from state budget	no, but specially earmarked account	yes, autonomous pension insurance institute
Structure of pension formula	flat-rate basic part + earnings-related component	benefit calculation based on individual wage history and contributory years
Minimum insurance period	25	15
Earnings considered in pension base	last 30 years (2016)	average of best 18 years
Pensionable age after transition period (men/women)	62/57–61	65/63[a]
Bonuses for late retirement	yes	yes
Penalties for early retirement	yes	yes, if prior to age 61/63 (with many exceptions)
Branch privileges	abolished	transformed into separate contributory funded tier

Note: [a] For a pension qualifying period of 20 years and above, the full pensionable age is 63/61 (men/women).
Source: Müller (2002a).

Appendix Table 2 Basic features of the voluntary supplementary funds in the Czech Republic and Slovenia[a]

Characteristics	*Czech Republic*	*Slovenia*
Year of introduction	1994	2000
Financing	fully funded	fully funded
Types of pension plans offered	personal	personal or occupational
Corporate constitution	Joint Stock Companies	Joint Stock Companies or Mutual Funds
Government incentives	state subsidy and tax incentives	tax incentives
Employers' contribution	tax-exempt (with ceiling)	tax-exempt (with ceiling)
Supervision	Ministry of Finance	Insurance Supervision Agency or Securities Market Agency
Number of funds	18	15
Number of members (thousands)	2,281	77
Members in % of population	22.3	0.04
Total assets (% of GDP)	2.3	na

Note: [a] Here, only the competitive supplementary schemes are covered, i.e. both the state-run 'First Pension Fund' and the monolithic supplementary scheme introduced in 1992 are left out of consideration.
Source: Müller (2002a).

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