

Carolyn M. Dudek and Pieter Omtzigt

Globalization's Challenge to Pension Reform in Western Europe

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Carolyn M. Dudek

Department of Political Science
Hofstra University, New York, U.S.A
psccmd@hofstra.edu

Pieter Omtzigt

Department of Economics
Università dell'Insubria, Varese, Italy
pomzigt@eco.uninsubria.it

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Abstract

The following suggests that demographic changes and the creation of a single currency in Europe has compelled greater EU intervention in pension reform. Although, traditionally pension reform has remained the domain of the domestic realm, increased European integration has necessitated lifting the issue of pension reform to the EU level. Capital flows among EU member states, the economic dependence among members of EMU and the unique institutional structure of the EU has facilitated increased attention at the EU level regarding pension reform. Politically, the EU presents a unique condition since national governments can use Brussels as a scapegoat to implement contested policies such as pension reform and accountability at the EU level is distinct from democratic configurations within member states also facilitating change within a highly contested policy area. Economically, the almost complete economic integration after the introduction of the Euro, means that countries are ever more dependent on policy choices in other Member States: no longer are countries able to keep all the benefits of prefunding, like increased investment, within their own borders.

This study concludes that both the political and economic importance of the EU and its uniqueness may lead to an important role of Brussels in the context of pension reform.

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Introduction

Impetus for pension policy reform is no longer dependent solely upon domestic economic factors and domestic political actors. In the context of the European Union (EU), global factors are shaping and perhaps driving the pension reform agenda. Specifically, the contribution of pension funds to foreign capital markets and deepening European integration have facilitated lifting the issue of pension reform from the domestic to the international arena. In particular, demographic shifts and international capital flows have created an economic necessity for members of the EU to coordinate pension reform. As a result, the unique institutional structure of the EU has enabled the European Commission to act as a significant domestic agenda setter regarding pension reform.

Many advanced industrialized countries are facing a crisis, as current pension policies become incapable of dealing with demographic changes. Across Europe and North America significant demographic shifts are occurring as life expectancy increases, population growth declines and the baby boomer generation leaves behind a legacy of a baby bust (see appendix). As a result of these changes, individuals who have paid into public pension systems may reap only meager benefits. As forecasters predict the failure of current pension schemes policy-makers are struggling to find policy solutions to ameliorate the situation.

Expenditure on pensions accounts for between 5% and 20% of GDP in most OECD countries and accounts for nearly half of government payments for social protection. When the baby boomers start to reach retirement age in ten years time, government budgets will feel the impact. Reform of pension systems has been a major topic in many domestic policy debates over the last decades. Past studies suggest that strong labor unions, public protest² or a country's institutional structures have defined and shaped pension policy reform (Epsing-Andersen, 1990, 1985; Flora, 1986; Ross, 2000; Guillén, 1999, 1992; Schmitter and Lembruch, 1979; Bonoli, 2000). Due to pension reform's controversial nature and since state run schemes are financed with national tax money, it is commonly assumed that pension reform does not and will not enter the realm of international politics³.

Today, however, changes in global finance and supranational institutions' influence upon domestic social and political structures have introduced a new dynamic to pension policy formulation. In the context of Western Europe, this has become increasingly apparent with deepening integration. Many incremental policy steps in the European Union have not only introduced pension reform policies high on the European agenda, but also the particular nature of the Union itself enables and facilitates lifting the issue from the domestic to the international arena.

² For example, in France during Alain Juppé's term and in Italy under Silvio Berlusconi the public protest regarding pension reform were massive and significantly contributed to the fall of these governments.

³ The World Bank has research and a program for how to establish or reform pension schemes. However, the World Bank's policy prescription is merely a guide to following successful practices, or learning from other countries' mistakes but, virtually no international coordination is suggested in this program. Similarly many Latin American countries have copied part of the Chilean reform, however no political bargaining among countries has occurred.

Thus, in light of global changes, how have international economic and political forces affected the impetus for pension policy reform? More specifically, has the unique situation of an integrated Europe affected such reform?

To answer these questions, we will specifically address two related research questions:

1. To what extent does the global economy affect pension reform? In particular, do moneys invested in private pension funds affect international capital flows and in turn influence other countries to adopt or refrain from adopting private pension systems?
2. To what extent does the European Union influence member state pension policy agenda setting?

Ageing in a global context

In 1994, the World Bank's publication *Averting the old age crisis* warned governments around the world of the future increase in the size of the elderly population that would threaten current pension schemes. Particularly developing countries are forecasted to face a large increase in the elderly population as can be seen in table 1:

Table 1: Over 60 as a percentage of the total population

	1999	2050
Africa	5	12
Asia	9	24
Europe	20	35
Latin American and the Caribbean	8	22
Northern America	16	28
Oceania	13	24

Source: Web site of the United Nations Development Program

The World Bank's report marked a considerable shift in international policy-making away from preoccupations over a growing population and the strain it puts on natural resources. Instead the report focused on a world population mainly composed of elderly and its consequence for economic and social policy. To remedy this situation, the World Bank strongly advocated a three-pillar structure for the provision of pensions, whose structure is summarized in the following table:

Table 2: Three pillar system as advocated by the World Bank (1994)

	First pillar	Second pillar	Third pillar
Provider/contract or	Government	Occupational plan or individual accounts (compulsory)	Voluntary savings in occupational plans or long term savings accounts
Present nature	PAYG (almost always)	Funded or PAYG	Funded
Ideal Nature (WB)	PAYG	Funded	Funded
Aim	Poverty alleviation	Living standard comparable to pre-retirement	To cater for individual preferences
Secondary Aim		Increase national savings and thereby growth	
Ideal Size	Max 10% of total wages in economy	At least as big as first pillar	

The first pillar is composed of a publicly provided scheme, like Social Security in the United States. In almost all cases it is on a pure Pay-As-You-Go (PAYG) basis, which means that current pension outlays are financed by current taxation and social security contributions. Ideally it should redistribute some money from the rich (they pay more taxes during their life) to the poor, such that all pensioners are above the poverty line. Chile is an example of a country, which put this first pillar on a funded basis and now a number of Latin American countries have followed suit.

The second pillar is negotiated between employers and employees and work-related. The money is used as a supplementary pension over the state pension. For private companies it should be funded in some way. That means that current contributions are saved and invested and paid out inclusive of their return, when the current generation retires. In some countries, most notably Germany and Italy, the money may be kept inside the company as a book reserve and is used as an inexpensive source of finance. This or even a company-run PAYG system is risky, because a company can default. Many (semi)-governmental organizations do run their "company"-plan on a PAYG-basis.

The third pillar refers to individual investments made to supplement pension payments. These often receive favorable tax-treatment if they are specifically earmarked for retirement, like the 401(k) plan in the U.S. Without exception this money is invested in an individual account.

Some notes on economic theory and pensions

Pension reforms in the Western world are essentially taking two forms:

Tightening of rules for qualifying for benefits: For example the retirement age is raised (in the US from 65 to 67), more years of contributions are needed to qualify for a (full) pension and the actual pensions paid are less generous.

Increase in the funded part of pension provision: This is done by either bolstering the second and third pillars, making sure that they are on a funded basis or by (partially) pre-funding state run PAYG systems. An example of the first policy is setting up extra tax-incentives for company plans or making them compulsory in certain circumstances. Examples of the second policy include the Social Security Trust Fund in the U.S., The Silver Fund in Belgium and the Oil Reserve Fund in Norway.

The aim of raising the qualifying age for retirement is to keep the budget balanced. In addition, it renders the system more equitable by eliminating privileges of certain groups in society. Increasing the funded portion of pension provisions is far more ambitious and costly. Pre-funding essentially means that current contributions will have to pay for current pensions and also for a capital reserve, which is being built up to fund future pension payments. It thereby puts a heavy burden on current generations and favors future ones.

On the equivalence between PAYG pension systems and explicit public debt

When a government runs a budget deficit, it borrows money to compensate for the shortfall and to that purpose issues explicit public debt. PAYG pension systems are a form of implicit public debt since there is a more or less explicit promise to current contributors that they will receive pensions in their retirement. The system cannot be terminated without either continuing paying benefits to people who have accumulated rights or defaulting partially or completely. The current implicit debt of a PAYG pension scheme equals the net present value of the accumulated rights of the system as of today. In many OECD members, the implicit PAYG debt amply exceeds formal government debt and gives a good indication of the future pension liabilities of many governments⁴. Pre-funding essentially aims to offset these with tangible assets in the form of pension funds (be it in the public or the private sector). This is important when considering the Maastricht treaty, which contains a ceiling on explicit public debt, namely 60% of GDP, but is completely silent on implicit debt and the sustainability of public pension schemes.

Relative merits of PAYG systems and fully funded systems

To design an optimal pension scheme it is useful to discuss the relative merits of the PAYG and fully funded pension schemes. We shall start with the merits at the micro-level: what does it give the average pensioner? A pension is an insurance policy for the risk that somebody lives long. The first question is how much return contributions deliver (before redistribution effects)? In an equilibrium PAYG system, the return a government can pay equals the growth of the wage base (on which it

⁴ See Auerbach et al. (1999)

imposes contributions), which roughly equals real GDP growth and is expected to be between 2% to 3% in the foreseeable future. The baby boom is a temporary departure from equilibrium. One way to manage this disequilibrium is to build up resources in a trust fund, when individuals work and paying them out, when they retire. These trust funds do not alter the fundamental arithmetic.

Currently a funded system can earn an almost risk-free return of just over 3% real per annum by investing in indexed government bonds or taking more risk by investing in stocks, which historically have earned a real 9% pre-tax and 5.4% after tax return (Feldstein, 1999). An appropriate mix of investment instruments, which also includes real estate, is mostly advocated to earn a higher return. According to standard investment theories, it is optimal to invest in as wide a range of assets as possible, as long as their returns are not perfectly correlated. This means that one should find an optimal mix between all available investments. Pension funds, however, can only trade in publicly available assets, whereas a PAYG system provides access to a non-traded asset, namely the human capital of workers⁵, which is measured by their wage. So for an individual it is optimal to have a mix of both systems, though opinions on the exact mix differ.

Optimal decisions at the individual level do not necessarily coincide with optimality at the aggregate level. Funding itself is perceived to have inherent advantages, because when done in the right way⁶ it will increase national savings. If a country is able to keep national savings and invest them within its own borders, this will deepen capital markets and increase long-term investment, which will in turn have two consequences. Firstly, a lower rate of return (interest rate) on these long-term investment will take place, because of the abundance of capital, and secondly a higher wage rate will occur⁷, because the increased capital makes labor more productive.

A small two country model

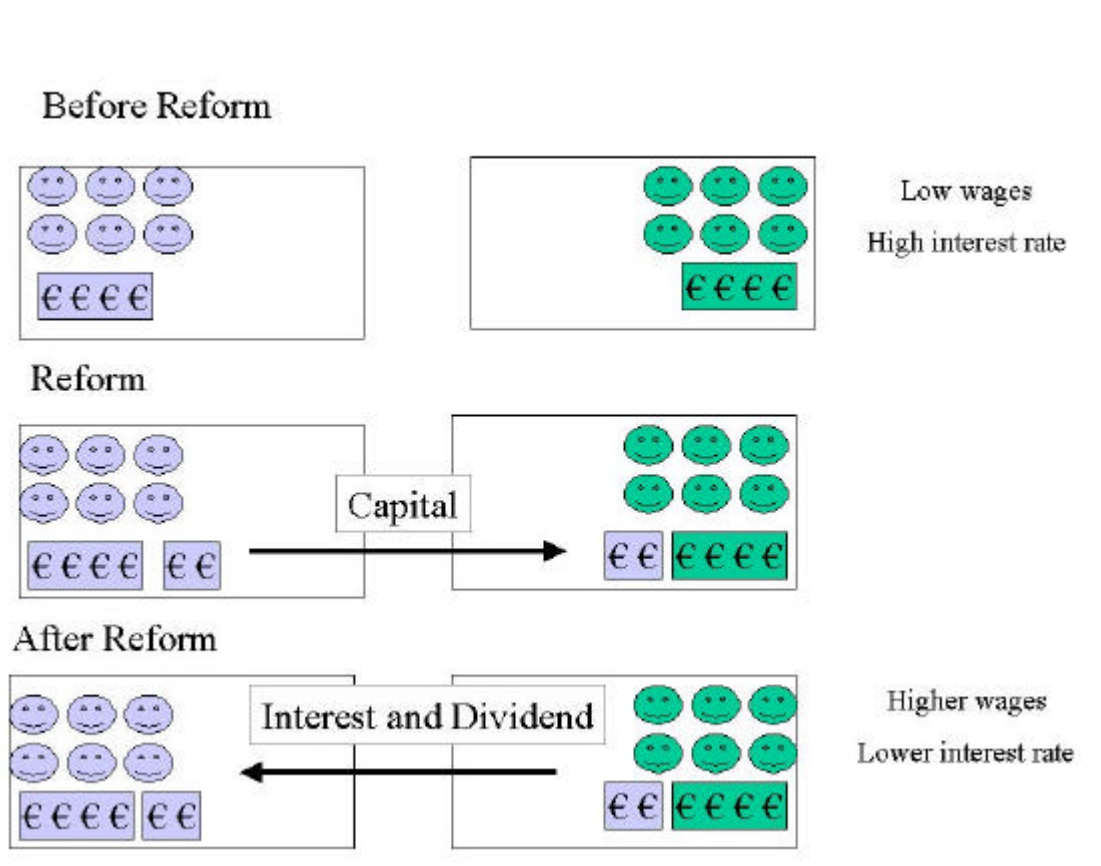
Consider two identical countries A and B, which form an economic union. Between them capital flows freely, but people do not move between the two countries. This is an abstract model of the European economy, where on average only 0.4% of the population moves from one state to another (In the US, the figure for interstate moves is about 6 times as high). In the beginning, both countries (of equal size) run a PAYG pension system and have a certain capital stock. This stock is relatively low and consequently wages are low and interest rates are high. Now country A decides to prefund its future pension obligations. In period two it builds up extra capital stock. One main consequence is that the people in country A in period 2 consume less. Country B continues to run a PAYG pension system.

⁵ See Merton (1984)

⁶ If a trust fund is just built up by writing out I.O.U.'s to it, as some authors charge the American government does with the trust fund, then it evidently does not raise national savings. If however the government would have issued that national debt publicly in the absence of the trust fund, then it does raise aggregate savings. Another objection levied is that if the pension fund buys riskier assets like stocks instead of bonds, then the whole change can be undone if private citizens lower their stocks holding by an equal amount and thereby offset the transaction. As many households do not privately own stocks, the effect can at most be partial.

⁷ We are making the common assumption that capital and labor are substitutes.

Prefunding country A accumulates extra savings, which is invested. Free movement of capital means that they will be invested in the most productive place available. This means that equal parts are invested in both countries: investment decisions require that the capital/labor ratio is equal, such that capital is equally productive in both countries and the profit made on investments is equal. So country A invests half of its extra assets at home and half abroad. After the reform the interest and dividend payments from country B pay for part of the pension outlay. The extra capital also has an affect on equilibrium wages and interest rates: it implies that labor becomes more productive and that wages hence rise. The abundance of capital leads to a fall in interest rates. See figure 1 below:



Country B, which has taken no policy action by itself, has been profoundly affected by the reform in country A: the wages of its citizens are higher, whereas the interest rates are lower. These effects mean that it is now less optimal for B to reform as well: lower interest rates make a PAYG system relatively more attractive with respect to a funded system: it is now (even) less inclined to follow the reform. If on top of that the growth rate in the area has also increased, as Feldstein (1999) argues, then the balance swings even further against reform. The question remains, however, why country A would prefund in the first place since part of the benefits accrue to the citizens of country B, whereas the cost (temporary higher tax rates and lower consumption) falls on its own citizens.

Pemberton (1999, 2000) therefore argues that countries should cooperate in reforming their pension systems: he even offers some examples of models in which the prefunding does not lead to a decrease in consumption in welfare as higher wages more than compensate. We consider the last examples (which are based on models

with large increasing returns to scale in the production function) unlikely to be realistic, but completely follow his first argument on the need to coordinate pension reforms.

Omtzigt (2001) also argues that reforms would proceed much faster if they were coordinated: at the moment each country only internalizes the gain from its own reform in the decision making process and takes the gain from the other country's reform as given. An optimal reform (from a welfare point of view) would require coordination, which could take place by means of an amendment to the European treaties. Note the clear differences between the two ways of reforming in table 3 below:

Table 3: Relative merits of competitive and coordinated reform

Competitive reform	Coordinated reform
Each country internalizes only the gains of its own reform	Each country internalizes its own reform and reforms in other countries
Slow prefunding	Prefunding takes place at a faster pace
Large domestic opposition to reform	Little resistance to reform

Now consider the entry decision of a country. If a country has large pension reserves and therefore a large capital stock, it will undergo a capital outflow upon entering an economic union, as capital will be able to earn a slightly better rate of return elsewhere. This gain is however more than offset by the fall in wages due to a lower capital intensity. So the model predicts that countries with high pension reserves should be less inclined to enter an economic union than countries with a low level of reserves.

Economic and monetary union is of crucial importance to the economic story above: pensions are without exception denominated in domestic currency. Before EMU investing in another country meant assuming an additional exchange rate risk for the pension fund. Consequently even in countries where pension funds had the liberty to invest a large part of their assets abroad, pension funds did not do so. The Dutch pension funds, which together with the UK pension funds, were not subject to any investment limits⁸ in the mid 1990s, increased their holdings in foreign assets from 40% of total assets at the end of 1998 to 64% at the end of 2000⁹. UK international pension fund holdings on the other hand have been constant at around 27% of total assets for the last eight years¹⁰

Pension fund assets in Europe

Different European Countries have vastly different amounts of funded pension reserves. The following figures from Phillips & Davis (2000) and Mercer (2000)

⁸ Apart from a 5% self-investment limit. Source: European Commission (1997)

⁹ Source: CBS (Dutch Statistical Agency), several on-line press releases: www.cbs.nl

¹⁰ Phillips & Drew (2000), figure 2.9

concern aggregate funded reserves for old ages and therefore include certain forms of life insurance:

Table 4: Pension assets as a % of GDP

Non-EU, non-EEA member	
Switzerland	127
Non-EU, EEA member	
Norway	34
EU, non-EMU members	
Sweden	118
Denmark	115
UK	93
EU, EMU members	
Netherlands	117
Ireland	54
Finland	50
Italy	23
Germany	15
Belgium	14
Austria	12
Portugal	12
France	5
Spain	5

A clear picture emerges: countries, which do not participate in EMU (and even stay out of the EU and European Economic Area), have far higher pension reserves than countries taking part in EMU.

Apparently there are two exceptions to this rule: Norway and the Netherlands. Norway however has a state-owned 'Petroleum Reserve Fund', which since 1990 invests the income of Norwegian North Sea oil. The fund is explicitly earmarked for future pension payments. Its assets reached 23% of GDP in 2000, but are excepted to increase to 74% of GDP by 2004, as oil revenues peak in this relatively short period. The Netherlands is a truly unique case since despite having one of the highest pension reserves in Europe, it does participate in EMU and has seen its pension investments flow to other countries at a massive scale.

Reforms currently under way in the single EU Member-States

The economic model above helps to explain two things:

Entry into a single Monetary Union and pension funds: countries with high pension reserves should be reluctant to enter such a union

Reform efforts in and outside the monetary union: reform efforts should be much weaker for countries inside the union (as long as coordination is absent) than for countries outside the union.

The first point is explained above (with the exception of the Netherlands). The second point is slightly more delicate, as it asks for a measurement of the pre-funding effort by the various countries. We, however, argue that only three countries have taken bold policy measures aimed at increasing pre-funding in the last 5 years: the UK, Sweden and Ireland.

On April 6 2001, stakeholders pensions were introduced in the United Kingdom. Under this scheme, almost everybody can make tax-deductible pension contributions to privately run pension schemes: it is particularly aimed at low earners and those that do not have access to company schemes and partly replaces the State Earnings Related Pension Schemes. The last one is financed on a PAYG-basis, whereas the stakeholders pensions are all prefunded. It is difficult to predict how many people will take out the new pension and thus how much extra prefunding is involved. (the British government massively under predicted how many people would opt out during an earlier reform in the 1980s). It is clear, however, that after the introduction of these pensions, almost everybody potentially has access to funded schemes. As the British state pension is below the poverty line and still falling relatively to average wages (some extra benefits are still available to those who only have the state pension), this step completes the long process of privatizing and prefunding, started by Mrs. Thatcher (for an overview, see Disney (1996)).

The Swedish Pension Reform Act of 1998 (Lag om inkomstgrundad ålderspension) stipulates that employees have to pay 18.5% of their income in pension contributions, of which 2.5% are in state-approved defined-benefit pension funds. This means that an extra 1.5% of GDP is being used for prefunding from January 1, 2001 onwards. The National Pensions Reserve Fund Act (2000) in Ireland instituted a Reserve Fund in which the government deposits a sum equal to 1% of GDP each year. The trustees of the fund decide on the asset mix and the fund is run outside the government sector, such that contributions to it do count as current outlays of the government. This is important, as Ireland will have to run a higher surplus before the transfer in order not to run the risk to hit the 3% deficit limit.

Other pension reforms in Europe are much more timid in nature: the 2001 German reform also introduces a funded element, just like Sweden, but this is set at only 0.5% initially¹¹. At the same time the state pensions are only marginally lowered in the future, such that the total contribution rate will still rise substantially in the future. The Italian pension reforms of 1992, 1995 and 1997 all aimed to increase the funded part of the Italian pension system, but as yet no real increase has taken place in pension funds (Covip, 2000). The Spanish government has introduced a fund, similar to the Irish one, but deposits only 0.1% of GDP each year. The Dutch and Belgians have opted for a retirement fund within the public sector, filled with only government debt.

¹¹ The original plan was far bolder, but parliament made deep changes to it.

In this way, the yearly contributions of the order of maximum 0.5% of GDP, are not classified as expenditure under the Maastricht rules and therefore do not count for the 3% deficit limit. Therefore they are just accounting identities and do not represent genuine efforts to prefund. In 2000 French prime-minister Jospin withdrew his pension reform act in the face of opposition: it would have marginally increased the role of prefunding by means of a state fund, but opposition was too fierce. Thus, two out of the three countries outside EMU, who least need it (they have the lowest age-dependency ratio in 2040 and already very high pension reserves) increased their efforts to prefund, whereas of the EMU-members only Ireland took a fairly bold step. The Irish situation is in fact very special from an economic point of view: its economy is booming with sustained growth rates of around 7% per year and the government records budget surpluses. Euro interest rates are too low by any standard for Ireland and the only solution to cool down the economy is to tighten budgetary policy. This is politically completely unfeasible. This pension fund was the only kind of expenditure, which does not further fuel the economic boom and at the same time is acceptable to voters. Still Ireland became the first country that received a reprimand from the other EMU members under the Maastricht rules for excessive spending.

Thus, it is clear that according to economic theory cooperation and coordination between countries is beneficial as the advantages of a deeper capital market and higher wages will now be spread over both countries. Moreover the resulting fall in equilibrium interest rates and possible increase in economic growth rates will mean that the country, which has opted for prefunding has effectively enabled the other country to maintain a PAYG system. Economic desirability of cooperation, however, does not in any way imply political desirability or feasibility. The political process is therefore studied in the next paragraph.

Pension Reform in an Integrated Europe

The global economy and more specifically an integrated Europe have created an environment necessitating the coordination of pension reform. Pensions initially were created to appease certain pressure groups or to alleviate poverty however; today pensions are 'big business'. Although the previous discussion suggests that international economic conditions and demographic changes dictate the need for pension policy reform, political factors will determine if such reform will actually occur. Willingness on the part of political leaders and the limiting or lack of political pressure from societal groups, particularly labor organizations, will determine the success and depth of pension reform.

The EU provides a special institutional framework that binds together member states and places limits on member state policies. For example, the convergence criteria to enter the European Monetary Union place constraints on government public spending. The 3% limit on deficit spending inhibits member states' public expenditure and also helps member states to implement traditionally unpopular austerity measures. Increasing political and economic integration has placed the EU in a very unique position. EU policies greatly affect and transform domestic

policies¹². The EU seems to have an unusual position providing not only constraints upon member state policy making, but also acting as a possible policy agenda setter within member states.

Discussions of the EU often disregard the notion of the EU becoming involved in social policy (Lange, 1992). Similarly, Ferrera and Rhodes (2000) suggest that although external pressures are important, it is “domestically generated pressures” that will bring about change of the welfare state, of which pension policy is a central component (p.20). Moreover, “to the extent that external constraints are important, they do not render impossible diverse institutional and normative designs for the welfare state.”(Ferrera and Rhodes, 2000: 20). Similarly, Clark (2000) asserts that the variation of pension policies across European countries will persist, however, we will witness an attempt at accommodating pension policies to the Anglo-American model.

According to Liebfried and Pierson (1996) social policy in the European Union is shared among different levels of government (national, sub-national/regional and supranational), thus creating a “multi-tiered” political system. The EU, including its policies and institutional structure in Brussels, has fundamentally affected the responsibility and competency over policy sectors that national and sub-national governments once enjoyed (Dudek, 2001; Marks et al. 1996). Most significant is the EU’s role in monetary and regulatory policy, which was traditionally the responsibility of national governments. Social policy, however, is claimed to have remained mostly in the hands of national governments “but their influence *has been* increasingly circumscribed and embedded in a dense, complex institutional environment” (Liebfried and Pierson, 1996: 4).

It seems that as national governments become more involved with one another within an institutional framework, as embodied in Brussels, there is more opportunity for the transference of pension reform policy options and ideas across borders. In addition, as European countries find their economies closely linked to their neighbors', pressures may arise from other member states or the EU itself to convince countries to adopt more sound policy initiatives. For instance, in a recent European Commission communication the Commission has acknowledged that pensions is a matter for member states to legislate, but the Commission suggests that member states should adopt a mixed pension system (European Commission, 2000). We suggest that as of yet there is no push to create a European run pension system. Instead, the EU, and in particular the Commission, is beginning to play a significant role in setting the agenda within member states to adopt not only more sound pension policies, but also specific policy prescriptions.

Theoretical Examination of Domestic Influences on Pension Policy

Pension reform is a particularly salient and highly sensitive issue. Many countries at different points in time have attempted to reform their pension systems but have been met with opposition due to domestic pressures. For instance, in Italy in 1970 experts realized the need for structural changes in the pension system, however

¹² For example see Giandomenico Majone’s *Regulating Europe*. (1996)

it was not until 1992 that reform was actually begun under the Amato government (Antichi and Pizzuti, 2000). Reform in Italy was only possible due to their desire to re-enter the European Monetary System and the inclusion of labor in the policy making structure (Antichi and Pizzuti, 2000).

Within the study of public policy there are many explanations to account for the kinds of policies chosen and how policies can be changed. In the context of pension policy in Western Europe it is evident that policies that have been adopted vary greatly among countries. Historically, the initial division of pension policy schemes stems from the introduction of social policies in the late 1800's and early 1900's. The two models that set the foundation of pension policy were the Bismarckian social insurance and Beveridge's¹³ poverty prevention scheme (Bonoli, 2000). Bismarck introduced his scheme in 1889, which was a program to allow retired industrial workers to receive a pension related to their earnings while they were working. On the other hand, the Beveridge plan was a means-tested pension scheme to aid the poor (Bonoli, 2000; Myles and Quadagno, 1997).

These two models of pension policies were chosen in order to accomplish very different goals. Bismarck chose to implement a social policy to quell discontent among industrial workers. For instance, in conjunction with his pension scheme he also had legislation to ban the political organization of workers (Bonoli, 2000). No pension provisions were given to other groups other than industrial workers since they did not pose a political threat. On the other hand, the Beveridge model, which the Danish actually first introduced prior to the publication of the Beveridge Plan, was meant to help alleviate poverty. Thus, it is apparent that the creation of pension policy was created to achieve very different purposes in different countries.

Since its inception, the political and economic implications of pension policies have changed significantly. Pensions are the cornerstone of the welfare state, providing a significant source of government substantive legitimacy. As the benefits and coverage of pensions have expanded, so to have citizen expectations. Moreover, as discussed earlier, pensions contribute significantly to national GNP. When considering pension reform it is important to take into account the significant political and economic implications. Thus, it is a complex matter to understand why certain policy options are chosen. Why do countries choose certain pension schemes and why has the reform of pensions been such a slow moving process? To answer such questions there are various perspectives that have been adopted. We suggest that there are four main schools to understanding pension reform which emphasize: industrialization, institutions, ideas and political mobilization.

The 'logic of industrialization' was an earlier school of thought regarding pension policy. It suggested that industrialization had created conditions that necessitated the creation of social policy. Bonoli (2000) points out that such a theory became difficult to support as the link between economic development and pension provisions seemed to be more tenuous. For instance, Bonoli (2000) proposes that the United States and Sweden compared provides a useful example to discount the 'logic

¹³ Bonoli (2000) points out that pension schemes similar to Beveridge's plan emerged prior to the publication of the Beveridge report in 1942.

of industrialization' since both countries have comparable economic development but differ considerably regarding the kinds of social benefits provided.

The 'logic of industrialization' attempted to use economic conditions as an explanatory variable to determine social policy adoption. Today, the global economy and EMU present a new dynamic that has the potential to influence the kinds of policies adopted. For instance, although not directly related to pension policy, in Italy and Spain severe budgetary austerity programs were instituted. In the case of Spain austerity measures were implemented to allow for European Community membership and to enable Spain to enter the European Monetary System (EMS). In the case of Italy, in 1992 following Italy's exit from the EMS a restrictive budget policy was adopted to ensure the re-entry of Italy into the EMS and entrance into EMU (Antichi and Pizzuti, 2000). Similarly, Gordon Clark (2001) suggests that the terms of global finance may cause continental Europe to accommodate their pension policies to pension schemes that are "at odds with continental political traditions" (p. 4). Although changes in the international economy may be necessary to promote pension reform it is still not a sufficient condition due to the political dynamics associated with pension policy. Thus, we have still not seen significant pension policy changes in Western Europe more recently.

Whereas the 'industrial logic' literature highlights economic factors some public policy theorists suggest that ideas or belief systems explains policy reform (Sabatier, 1988; Sikkink, 1990; Clark, 2000). This theoretical body suggests that policy change relates to changes in belief systems and the influence of ideas themselves. In relation to pension policy it appears that certain models of pension policy have gained support and have been put in practice. Some suggests that the Anglo-American model has become the predominant model of economics and pension reform (Clark, 2000; Aglietta, 2000). The Anglo-American model focuses on neo-liberal ideas and places emphasis upon the "balance between government and private provisions of retirement income and the benefits of market provision rather than the threats posed by demography are at the core of the debate." (Clark, 2000: 4). Such a model incorporates "acceptance of levels of risk and inequality at odds with continental political traditions" (Clark, 2000: 4; Bonoli, 2000).

The policy reform proposals being discussed in EU member states and policy proposals from the European Commission support the idea that the Anglo-American model is becoming a popular policy option. The impact of ideas, however, begs the question how these ideas become popular and why elites choose to adopt certain policies over others. Thus, it seems that ideas need a vehicle in which to have an impact.

Institutionalism may provide greater explanatory value to identify what influences pension policy choices and reform. Political institutions are collections of interrelated "rules and routines that define appropriate actions in terms of relations between roles and situations (March and Olsen, 1989:160)." One institutionalist approach to understand public policy suggests that the variation of policies across countries within the same policy sector is explained either by the political structure hypothesis or the policy style hypothesis (Lane and Ersson, 1994). The political structure hypothesis suggests variation of policies within the same sector across

countries since decision-making structures play a significant role in the way policies are created and implemented (Lane and Ersson, 1994). Thus, structural characteristics within countries determine policy choices more than the policy issue itself. On the other hand, the policy style hypothesis explains the variation in the same policy sector across countries also due to structural differences of policy-making and implementation, but this hypothesis also takes into account that changes in time and tradition can alter these structures. The underlying basis of the policy structure and policy style hypotheses is that institutions shape public policy.

Epsing-Andersen's (1990) seminal work incorporates an institutionalist approach to categorize types of welfare states. The typology created focuses on the variation of regime types in reference to welfare states. The three major typologies of Epsing-Andersen include Scandinavian or social democratic, Anglo-Saxon or liberal welfare states and Continental or corporatist welfare states. Later literature suggests that Southern European countries namely, Italy, Greece, Spain and Portugal follow a distinct model (Ferrera, 1997; Rhodes, 1996, 1997). Epsing-Andersen demonstrated that the perceived role of the state, the logic of state activity and the view of what private and public realms should provide determined the kinds of welfare policies adopted.

In the context of pension policy Epsing-Andersen (1990) distinguishes two types of pension schemes: public and private. Public systems basically refer to the PAYG system, pillar 1 whereby current taxation and social security contributors finance current pension payouts. On the other hand, private systems, other wise called capital systems include either occupational pension plans or individual annuities, pillars 2 and 3. The institutionalist approach asserts that the variation of pension schemes across countries is based upon culturally defined ideals concerning what is the appropriate role of the state. These rules and structure of the state are a reflection of embedded societal beliefs and structures. As ideals become institutionalized they also become reinforced. Institutionally entrenched ideas regarding the relationship between public and private sectors define the responsibility of government and contribute to the formulation of pension policies. As a result, pension reform has occurred at a slow rate. In this way, institutionalism provides a convincing argument to explain why pension schemes vary across countries and remain varied.

Another model to understand government pension policy choices emphasizes the role of politically mobilized groups. In particular this approach highlights the importance of protest, labor unions and ideologically left leaning political parties in the creation and type of pension policies within countries (Lagares, 2000; Antichi and Pizzuti, 2000; Guillén, 1992, 1999). For instance, in Italy the long time awaited pension reforms only came about with the inclusion of labor unions in the reform process (Antichi and Pizzuti, 2000). Pension reform, since it is a controversial topic needs strong public support. Lack of public support has resulted in major political failures. For instance, in France during Alain Juppé's term and in Italy under Silvio Berlusconi massive public protest regarding pension reform significantly contributed to the fall of these governments.

The four approaches to explain pension policy choices, reform or lack thereof, each provides a certain amount of explanatory value, however it seems that political mobilization and institutional approaches provide more explanatory value. It must be kept in mind, however, that these approaches were designed to understand pension reform in the context of domestic politics. Within an integrated Europe will these approaches, specifically institutionalism and political mobilization, have the same explanatory significance?

The unique position of the institutions of the EU

The EU presents a unique political arena that can alter significantly the policy options available for pension policy reform. First, the EU itself is a forum for discussion and debate. In this way, countries interact on a regular basis and share and provide ideas creating new policy networks or epistemic communities. Thus, different policy ideas can be introduced to pertinent political agents that may otherwise have not emerged within domestic dialogues regarding pension reform. Second, the interdependence of the economies of EU members and particularly the twelve members of the monetary union presents an unusual situation, whereby member states are increasingly concerned with the economic well being of their partners for their own self-interest. Thus, member states may become more vocal regarding the domestic policies of other members. In the past, it was unheard of for foreign governments to critique the type of pension policy chosen within a country¹⁴. With deeper European integration we are beginning to see countries that have relatively more successful pension policies pressuring the countries with less effective policies to reform. For instance there have been some rumblings from Dutch officials demanding the Italians to reform their PAYG pension system (interview, 2000).

Third, the EU itself has become an agenda setter for national policy makers. Although the EU in certain sectors cannot usurp the powers of the national or regional governments it can present certain parameters that promote the adoption of certain policy options above others. In this way, the EU can constrain the policy-making autonomy of national governments (Ferrera, 2000). European Monetary Union and other policy initiatives have placed the Commission in a unique position to have significant influence upon member states' pension policy choices.

Fourth, the EU provides a useful buffer for political leaders. Within a strictly domestic arena, political pressures regarding pension reform can come from labor groups and public protest. It is clear that pension reform is a highly contested policy area and there are many strong domestic actors that can block policy reform. On the other hand, the EU provides a "scapegoat" mechanism that allows public officials to adopt unpopular policy options that are EU suggested or imposed. In response to public outrage, public officials can point the proverbial finger at Brussels and as a result avoid political heat. Such practice was seen in Italy and Spain while they implemented austerity measures to meet the convergence criteria of monetary union membership. For example, Silvio Berlusconi, leader of the opposition in Italy, stated

¹⁴ We can see this change in the concern for member's domestic policies regarding border control and immigration policy. With the free movement of people throughout Europe, European governments have been outspoken regarding the practices of border control and immigration policy of their member countries.

during the election campaign that *'No acquired pension rights will be touched'* but *'What we have to do will be based on what Europe will impose on us'*¹⁵

The EU has transformed domestic politics through its re-allocation of competencies to different levels of government and its affect upon the role of domestic actors and institutions to influence policy-making (Marks et. al., 1996). The EU itself is a unique institution that like domestic institutional structures has its own "rules and routines that define appropriate action." (March and Olsen, 1989: 160). Theorists suggest that the Commission and other EU institutions have moved forward the process of integration (Burley and Mattli, 1993; Burley-Slaughter, 1991; Alter and Meunier-Aitsahalia, 1994).

Fifth, the impact of domestically mobilized groups at the EU level is quite different than within the domestic realm. As mentioned earlier, in the domestic realm labor unions and other forms of political mobilization have influenced the passage or blockage of pension reform. In the context of the EU, representation and the ability or willingness of domestic interests to change the EU policy arena is significantly altered.

One, political leaders within most of the institutions of the EU are not directly elected officials. The only EU institution composed of directly elected official is the European Parliament. Hence, one of the major critiques of the EU is its democratic deficit. Such critiques tend to focus on the absence of directly elected officials in the two most influential institutions: the European Commission and the Council of Ministers. Although the Maastricht treaty attempted to empower the European parliament many critics suggest that the change is not sufficient to remedy the deficit. As a result, policy-makers at the European level do not have the same electoral pressures as those within member states.

Two, political mobilization at the EU level differs significantly from mobilization at the domestic level. Often organized interests lobbying or protesting EU policies do not choose to do so at the EU level. Instead, organized interests prefer to operate within the domestic arena since that is where their resources and networks are located (Imig and Tarrow, 2001). Although European labor unions do have representation at the EU level, they do not have the same kind of impact at the EU level as they do within domestic politics. In Brussels, business is better represented and the objectives of different European companies are fairly well aligned, such that they forcefully and unanimously argue for fairly deep cuts in pension provisions in a common report, entitled 'European Pensions, an appeal for reform (European Round Table of Industrialists, 2000). Their counterpart, the European Trade Union Confederation, is far more divided: national trade unions in countries which prefunded systems are wary of calling for integration in Europe, because that implies they have to pay and all are weary to call for cuts. Consequently their resolutions on pension reform are full of compromise:

¹⁵ Interview on Radio Anch'io, February 20, 2001. These quotes are taken from the official web site of Forza Italia, the party Berlusconi leads: <http://www.forza-italia.it/politica/articolo.jsp?id=280>. The Italian text is: "Sulle pensioni nessun diritto consolidato sarà toccato" and "Ciò che si dovrà fare sarà in base a ciò che l'Europa ci imporrà"

As regards the financial aspects, it is vital to establish a minimum number of rules because it is essential to protect the rights of contributors and pensioners..¹⁶

Without specification this phrase remains rather empty.

EU activity in pension policy

Most scholars that examine the role of the EU in social policy suggest that thus far the role of the EU has been quite limited. The EU's insertion into pension policy has developed slowly over time. The Commission has had two aims: 1) to make sure national pension regulations fairly treat people who move between countries, and 2) to create a single market for pillar 2 and 3 pensions. More recently it has started to promote an increased role for pillar 2 and 3 at the cost of pillar 1, which is nine times as large as the other two combined.¹⁷

In 1971 regulation 1408/71¹⁸ was enacted to ensure workers who had lived and paid contributions in several Member States were treated fairly along with their dependents. Following this regulation an enormous amount of case law arose over the years which has been favorable for migrant workers. In July 1990 in his effort to create a single market Sir Leon Brittan announced a sweeping directive, which would both protect the occupational pension (second pillar) of a migrant worker and create a single market for pensions¹⁹. The commission sent a draft proposal to the Council in October 1991. The Member States fiercely opposed the provisions in the bill and the proposal became watered down. These objections were reinforced by the collapse of the ERM in 1992 and 1993, during which countries faced massive speculative attacks against their currencies: the last thing they desired was to enable another large amount of money to be able to move to other countries.

In the end a country would still be able to force a pension fund to hold 60% in matching (i.e. domestic) currency. Among others, France still wanted 80%, but the Commission refused and took a highly unusual tact and withdrew the draft directive on December 6 1994. Eleven days later it published an almost unchanged proposal as a communication in the official journal²⁰, which by-passed the Council. France went to the European Court of Justice, which duly annulled the communication^{21,22}. Following the Court's decision the Commission was back at square one.

Another attempt to put pension policy on the Commission's docket re-emerged with the creation of a high level working group. The group, led by Simone Veil, formed in 1996 and proposed a directive, which only dealt with the first issue: the pillar 2 provisions for migrant workers. The Commission thus proposed a working group

¹⁶ ETUC resolution approved by the Executive Committee during its meeting of 13 and 14 December, 2000, paragraph 3,4

¹⁷ European Commission (1997)

¹⁸ Regulation 1408/71, articles 44-51. Article 51 is modified by Council regulation No 118/97

¹⁹ In 2001, a multinational active in 15 EU countries, still has to run 15 pension funds.

²⁰ 94/c 360/08

²¹ Case C-57/95 *France v Commission*, decision of the court: *OJ C 142, 10.5.1997*

²² For a comment on the judgement, see Adneus, 1998.

directive to the Council in October 1997. Following agreement at the 1998 Luxemburg Council meeting, the directive became effective on June 28 1998²³ By June 2001, countries are to implement the directive.

The thorny issue of a free market for supplementary pensions, the second Commission aim, was addressed in a green paper published October 1997²⁴. After a long consultation process, in which the Commission ensured itself of a mandate with the Council conclusions in Lisbon and Maria de Feira, it finally published a proposal for a directive in 2000 and sent it to the Council and parliament²⁵, who under the Maastricht rules, now have to take co-decision. The proposal forces member states to abolish most of the restrictive rules on investment allocation and enables migrant workers to stay in their old pension scheme, when they are on an assignment in another country. It stops short of giving workers the option to shop around for pensions in the EU, as this would require a great deal of tax harmonization. The Commission currently is promising a proposal to deal with this issue.

In preparing the Member States for this directive, the Commission has taken an increasingly proactive approach. In May of 1999, the Commission issued a communication summarizing critiques solicited from member states in reaction to a Green Paper dealing with pension reform (European Commission, 1999). The Commission communication asserts that pension schemes are an important policy that remains within the domain of nation-states. However, the communication proposes the creation of a Community framework to promote the creation and sustainability of funded supplementary pensions. Specifically, the document highlights the burden demographic changes will have upon public expenditure. Thus, as a way to help fund public pensions the document supports the policy of supplemental pensions and proposes a European plan to ensure their development.

Within the Commission communication there is an interesting member state critique of the Green paper. Member states felt that the Commission did not emphasize sufficiently the social aspect of pensions, but instead focused more on “pension funds as a vehicle to create European capital markets” (European Commission, 1999a: 10). In response to this criticism, the Commission conceded to put the protection of beneficiaries as a priority. However, the Commission stated that the “role that EU capital market integration can play in favor of growth and employment should not be disregarded: efficient and transparent financial markets can facilitate access to capital and enhance capital productivity” (European Commission, 1999a: 11). It is clear from this statement and others that will be discussed that the EU’s reason for wanting to play an agenda setting role in pension policy is distinct from traditional domestic reasons for pension policy reform.

In the past, pension policies were used to either help the poor, provide socio-economic stability or to quell political pressures from labor. In the context of the EU, it seems that the underlying reason driving the EU’s interest in pension reform is the preservation of the European Monetary Union and more generally strengthening of

²³ Council Directive 98/49/EC

²⁴ COM(97)283

²⁵ COM(2000) 507 final and 2000/0260(COD), published in the Official Journal: (2001/C 96 E/06)

the European economy. Thus, the EU and its policy-makers will tackle the issue of pension reform from a very different perspective than member states might.

In August of 1999 the European Commission published a document with the help of reports from member states. This report, “The Evolution of Social Protection in the Member States” summarized the various kinds of social policies linked to employment, retirement and health. Specifically, the report emphasizes the problematic nature of pension reform within member states.

The social security tasks themselves, as well as the institutions responsible for managing such tasks, continue to be a matter for discussion in a number of countries. The various underlying balances and compromises of social security –which are specific to each country—such as the link between the public and private sector are a particular subject of debate. The acknowledgement of financial difficulties or the anticipation of financial deadlock, especially in the retirement pension sphere...casts doubt on the long term viability of certain branches of the social security system if legislation does not change. However, despite the clear resolve to implement changes in some cases, such changes are introduced only sporadically and in a way that is highly controversial...(European Commission, 2000b: 6)

From this report the Commission demonstrated the need for reform as well as the problems within the domestic arena blocking change. From the tone of this publication it seems that the Commission began to assert itself as a mechanism or conduit to help push forward needed pension reform.

In October of 2000, the Commission published a communication to the European Council, European Parliament and the Economic and Social Committee as an outcome of the Council’s Lisbon meeting in March 2000. The Lisbon meeting enabled a High Level Working Party²⁶ on Social Protection to prepare a report based upon past Commission communications and work done by the Economic Policy Committee. The purpose of this report is to pay particular attention to the “sustainability of pension systems in different time frameworks up to 2020 and beyond, where necessary.” (European Commission, 2000).

The October communication presented a very direct reference to EU involvement in setting the policy agenda within member states. The communication states:

While each Member State remains responsible for its pension system, it is clear that they also have much to learn from each other. Furthermore, the sustainability of pension systems will determine to a significant extent the European Union’s ability to achieve the promotion of a high level of social protection, which is one of the fundamental objectives defined in Article 2 of the Treaty establishing the European

²⁶ A Council decision in June 2000 replaced the High Level Working Party with the Social Protection Committee.

Community. This is why the European Council has called for co-operative exchange on the future sustainability of pension systems (European Commission, 2000:2).

In December of 2000 the Presidency of the Council following the meeting in Nice reiterated the desire of the EU to promote co-operation among member states regarding pension reform.

The European Council approves the Council's approach, which involves a comprehensive assessment of the sustainability and quality of retirement pension systems. The European Council invites Member States, in cooperation with the Commission, to exchange their experience and present their national strategies in this area. The results of this preliminary overall study on the long-term viability of pensions should be available for the European Council meeting in Stockholm (European Council, 2000:art 20).

In February, prior to the meeting in Stockholm the Commission published a proposal regarding occupational retirement (European Commission, 2001). In this explanatory memorandum the Commission expressed the need for a "Community legal framework covering institutions for occupational retirement provision." (European Commission, 2001; art. 1.1). According to the proposal,

The Lisbon European Council placed strong emphasis on the need to integrate financial services and markets within the Union. A single financial market will be a key factor in promoting the competitiveness of the European economy, the development of the new economy and social cohesion. That is why Heads of State and Government called for the Financial Services Action Plan to be implemented by 2005. In its conclusion the Presidency stresses that priority must be given to removing barriers to investment in the field of pensions (European Commission, 2001, preamble)

Commissioner Frits Bolkestein's speech entitled "Diffusing Europe's Pension Time bomb" reinforces the sense that there should be a European response to the problems facing pensions. Bolkestein explains, "The Commission is encouraging member states to set in place a comprehensive reform process." (Bolkestein, 2001). Specifically, he points out the need for

Running down public debt at a faster pace so as to lower the interest burden and offset increased pension spending;

Raising employment rates, especially of older workers and women, so as to reduce the ratio of dependants to active workers

Proceeding with further reforms of public pension systems, including moves toward greater reliance on funding (Bolkstein, 2001).

Similarly, following the first day of the European Council's meeting in Stockholm, Commissioner Solbes asserted that the Council endorsed the Commission's push to get "member states to develop comprehensive strategies" (Solbes, 2001).

The outcome of the Stockholm meeting sets up certain objectives of the EU. One objective is to act in accordance with the Commission's October 2000 proposal and to invite Member States to strengthen their cooperation regarding pension. In addition, the Council also stated its support for "cooperation between Member States on the modernization of pension systems to ensure their sustainability in the context of economic demographic changes." (www.europa.eu.int, 2001).

The Commission's and European Central Bank's numerous alarming reports regarding the forecasted failure of pensions have convinced a number of governments that reform and specific kinds of reform are needed. For instance, Prime Ministers Kok, of the Netherlands, and José Mariá Aznar, of Spain, at the Econfin Council on March 6 2001, presented a proposal calling for a greater amount of prefunding in the Union²⁷. The topic was subsequently discussed at the European Council in Stockholm on March 23-24, which concluded that

"...Where appropriate, the potential of the open method of coordination should be used to the full, particularly in the field of pensions, taking due account of the principle of subsidiarity..."²⁸

It is clear that the more recent Commission proposals and Council meetings suggest that the EU in the future will take a more active role in promoting cooperation of pension policies among member states and promoting certain pension options, i.e. funded pensions. The Commission has recognized that demographic changes necessitate pension reform. Moreover, the impact pensions have upon capital markets and public pensions are also of concern for the EU with its desire to create a strong and viable integrated market, economy and monetary system. The Commission cannot nor is attempting to usurp the policy-making autonomy of member states regarding pensions, however, it seems that the Commission is attempting to act as an important agenda setter of domestic politics regarding pension reform and while it is not seizing the policy-making autonomy, it is indirectly limiting it by its very actions: once pension funds fall under the European free market, the Commission has managed to exert a strong European influence on the largest asset within the European Union.

Conclusions

Pension reform is of grave concern for many countries in West Europe. It seems, however, that pension reform must be understood under the lens of increased European integration and greater globalization. Earlier work, which does not consider the European dimension of domestic policy leaves out an important variable. Currently, an EU directive aiming to harmonize rules has been proposed, whereas a second one dealing with tax harmonization is under way. These two proposals have the possibility to limit the choices of national policy makers when they reform their respective pension systems.

²⁷ Source: Press release of ANP, 6 March 2001: Interview with Vermeend, Dutch minister of social affairs.

²⁸ Presidency Conclusions, Stockholm European Council, article 32.

Due to the economic arguments discussed advocating increased cooperation in pension reform:, it seems that the European Union would be the most obvious agent to initiate cooperation. The process of increased integration makes such cooperation ever more desirable, a fact which most policy makers are now slowly accepting. For instance, Aznar and Kok's recent proposal demonstrates that some Member States are even willing to put reform on the European agenda. Furthermore the above discussion demonstrates the clear link between EMU participation and prefunding of pensions respectively the current speed of reform.

Although national governments still play a significant role in pension policy and its reform it is clear that the EU is taking a more active role setting the agenda for reform within member states. The unique institutional design of the EU and its facilitation of interdependence among member states has created a situation whereby the EU is becoming increasingly active in policy areas once the domain of domestic actors. Likewise, pension policy, a highly contested domestic issue, is being dealt with at the European level. Proposals currently being discussed in Brussels may even increase the role of the EU in pension reform.

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Appendix: Projections of old age dependency ratio

	Old age dependency ratio in 2050
North-West	
UK	48.5
Ireland	46.6
Finland	50.6
Sweden	48.5
Denmark	43.7
NL	46.9
Central	
Belgium	52.0
Luxembourg	43.5
Germany	56.1
France	53.2
Austria	57.7
Mediterranean	
Italy	69.7
Spain	68.7
Portugal	50.9
Greece	61.6