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Giuliano Bonoli

The European pension policy landscape is generally depicted as a major building site, where governments are scaling back the pension systems they have inherited from the postwar years in order to adapt them to population aging. Europe is often seen as a graying continent that will have to face the effects of a demographic time bomb and that needs to reduce its pension commitments radically. As a matter of fact, in the last decade pension policy has gained unprecedented levels of prominence in the political arena throughout western Europe, and several countries have cut pension schemes.

This image reflects some broad trends, but a closer analysis of pension policy in western Europe reveals a number of other important developments. Pension systems are not simply being adapted to population aging but are responding to at least two additional sets of pressures: the new career profiles that have emerged with the transition to a postindustrial labor market structure and highly integrated international financial markets. Current pension systems were designed in a time characterized by stable labor markets and limited cross-border capital mobility. Changes in these two areas, as well as in the demographic composition of societies, create economic and political pressures to rethink part of their structure.

European pension systems are exposed to these pressures in broadly similar ways. However, the way in which they respond to them varies considerably across countries and is to a very large extent shaped by the institutional structure of the pension systems that are currently in place. Population aging, labor market changes, and stronger financial market integration generate different political demands and policy responses depending on whether countries have a pension system based on the social insurance model, where one single public pension scheme provides the bulk of retirement income to the whole resident population, or a multipillar system, where the state takes responsibility only for basic income security and additional coverage is provided by occupational and private arrangements. European pension systems are path-dependent; micromechanisms link existing institutional structures to new policies.[1] In particular, policymakers face different incentive structures and political pressures under different pension institutional settings. Empirically, pension politics and reforms in eight western European countries will be examined. Four have social insurance pension systems, financed predominantly on a pay-as-you-go basis (France, Germany, Italy, and Sweden), and four have multipillar pension systems, in which the state provides only a modest benefit and the bulk of pension provision is left to the private sector (Denmark, the Netherlands, Switzerland, and the United Kingdom).

Social Insurance and Multipillar Pension Systems

During the postwar years comprehensive pension systems were constructed in all western European countries. The rudimentary prewar schemes, which offered modest coverage to some sections of the population only, were expanded and combined with minimum guarantees and supplementary pensions. By the late 1970s virtually every country in western Europe provided reasonably good pension coverage to the whole resident population. The roads taken by individual countries to set up comprehensive pension systems, however, differed sharply and followed from decisions made at earlier stages of pension policymaking. As a result, today one can identify two types of pension systems: social insurance and multipillar pension systems. This divergence has generally been recognized, but so far no consistent terminology to label these two worlds of pension provision has been adopted. The social insurance/multipillar distinction presented here roughly corresponds to the distinction between Bismarck and Beveridge, mature systems and latecomers, and social insurance and latecomers.[2] The main difference is that it focuses not only on the sort of benefits that are distributed but also on the way in which pension schemes are financed. This focus has important implications for pension reform trajectories.

Social insurance pension systems are based predominantly on schemes of Bismarckian inspiration that grant earnings-related benefits to former workers on a contributory basis. Typically, benefits depend on the contributions made while working. In addition, social insurance pension systems generally include a means-tested minimum pension, provided to those who reach the age of retirement without having paid contributions or with a contribution record that is not sufficient to grant them an adequate pension. These schemes are financed on a pay-as-you-go basis; current pensions are financed by current contributions. Because of the earnings-related nature of public pension coverage in social insurance countries, private pension provision did not develop to a significant extent, at least until very recently. The generosity and encompassing character of social insurance pension systems have crowded out private provision. To this world of pension provision belong most continental European countries, such as Germany, France, Italy, and Sweden.

Multipillar pension systems are found in countries where state pensions provide only a flat-rate minimum benefit, sufficient to cover basic needs only. Typically, the objective of this sort of provision is not income maintenance during retirement but the prevention of poverty among the older population. This limited role of the state in pension provision has left ample room for the development of private and/or occupational pensions, which have gradually been integrated into the pension systems of the relevant countries, often on a compulsory or quasi-compulsory basis. Multipillar pension systems combine two different financing methods: their basic pensions are of the pay-as-you-go type, like public pensions in social insurance systems, whereas their private and occupational pensions are generally fully funded, that is, current contributions are used to finance future benefits. These systems exist in the U.K., the Netherlands, Denmark, and Switzerland, where the state basic pension is only moderately related to earnings.

The distinction between social insurance and multipillar pension systems is visible in the relative importance of the first and second pillar in a pensions system. Social insurance countries spend a considerable amount of their GDP on public pensions and have a small private pension sector; multipillar countries spend a lower proportion of their national income on public pensions but have larger private pension systems. Table 1 provides an overview of pension systems in selected OECD countries according to these two dimensions.

At the end of the *trente glorieuses* (late 1970s), regardless of the model adopted, European pension systems were able to fulfill the two essential functions of pension provision: poverty prevention in old age and income replacement during retirement.

Table 1 Public Expenditure as a Percent of GDP (1996) and Financial Assets of Pension Funds (1998 or Most Recent Year) in Selected OECD Countries

	Expenditure on public pensions, % GDP	Financial assets of pension funds, % GDP
Social insurance countries		
France	10.36	na
Germany	10.29	3.3
Italy	10.99	3.2
Sweden	8.27	2.7
Average	9.97	3.1
Multipillar countries		
Denmark	7.73	21.5
Netherlands	6.75	85.6
Switzerland	6.71	74.9
United Kingdom	6.46	83.7
Average	6.91	66.4

Source: OECD SOCX (CD-ROM); OECD, *Institutional Investors Statistical Yearbook 2000*, (Paris, OECD, 2001), Table S.8.

Whether they did so with a large social insurance scheme and a means-tested minimum or through a modest basic pension supplemented by private or occupational provision did not have a substantial impact on the living standards of older people. From the 1990s onwards, however, the institutional structure of the pension system has mattered considerably in terms of its vulnerability to social, economic, and demographic developments.[3] The most important as far as pension policy is concerned are population aging, the transformation of employment to increasingly part-time work, career interruptions, low wage employment, and the increased exposure of national economies to international capital markets. These developments are hitting western European societies and economies in broadly similar ways and to similar extents. The way they influence pension policy, however, differs considerably depending on the institutional structure of national pension systems.

Population Aging and Pension Financing

It is often assumed that social insurance countries face the biggest sustainability problems in relation to population aging. Multipillar systems, because a larger proportion of pensioners' income is prefunded, are expected to suffer less as a result of the demographic transition. However, this view must be somewhat qualified. Funded pensions, in fact, are also likely to be affected by population aging, and, all other things being equal, will deliver lower benefits than today. Differences between these two models of pension policy with regard to how they deal with population aging may turn out not to be so substantial. Where the two systems certainly differ is in how population aging translates into political pressures.[4]

In social insurance countries population aging is expected to result in a substantial increase in public pension expenditure and, all other things being equal, will require contribution and/or tax increases. Governments are consequently put in front of a powerful dilemma: either they increase contributions for current workers, or they reduce pension benefits. Each of these two measures is politically difficult. Current workers are likely to resist contribution increases, because such increases will reduce their disposable income and, since these schemes operate on a pay-as-you-go basis, the inreases will not necessarily result in better pensions for them. Cuts in pension benefits will also be extremely difficult to implement. It is virtually politically impossible to curtail current benefits. The only available alternative is to reduce benefits for future retirees, which can also be extremely unpopular with current workers.[5]

Things look rather different in multipillar countries. Here governments are directly responsible for a relatively small part of the overall intergenerational transfer, the bulk of it being performed by private and occupational arrangements. Thus, increases in public pension expenditure will be smaller in these countries and as a result more manageable. To preserve current benefit levels may require increased contributions to funded pensions. This kind of increase in contributions is likely to be much less politically damaging. First, increases are not necessarily decided by governments but can result from decisions made by the governing structures of occupational pension funds (trusts, social partners). Second, in funded systems there is a direct link between higher contributions and better pensions: a compulsory payment to a funded pension is thus less likely to be perceived as a tax. Population aging may also result in lower than expected occupational pensions, but governments in this case are better protected against the risk of electoral punishment because they are not directly responsible for benefit levels.

Pension expenditure projections leave little room for optimism in social insurance systems. According to the data presented in Table 2, the four social insurance countries covered in this study may spend on average up to 16–17 percent of their GDP on public pensions between 2030 and 2050. In contrast, in the four multipillar countries public pension expenditure on average is not expected to exceed 9–10 percent of GDP during the same period. These projections need to be looked at with caution and should be considered as indications of trends rather than precise measurements. However, the size of the gap in public pension expenditure between social insurance and multipillar countries throughout the period covered, around 7 percentage points

Table 2 Public Pension Expenditure Projections (Percent of GDP)

	2000	2010	2030	2050
Social insurance countries				
France	9.8	9.7	13.5	14.3
Germany*	11.5	11.8	16.5	17.5
Italy	12.6	13.2	20.3	21.4
Sweden	11.1	12.4	15.0	14.5
Average	*11.2*	*11.8*	*16.3*	*16.9*
Multipillar countries				
Denmark	6.4	7.6	10.9	11.5
Netherlands	5.7	6.1	11.2	11.4
Switzerland	7.1	8.4	11.7	Na
United Kingdom	4.5	5.2	5.5	4.1
Average	*5.9*	*6.8*	*9.8*	*9.0*

Source: P. Roseveare, W. Leibfritz, D. Fore, and E. Wurzel, *Ageing Populations, Pension Systems and Governments Budgets: Simulation for 20 OECD countries*, (Paris: OECD, Economic Department Working Papers, No 168, 1996), Table 3, pp 17-18 (baseline scenario), for Switzerland: own calculations.

* Note: For Germany, the effects of the 2001 reform are not included.

of GDP, suggests that demographics will affect these pension systems differently. This finding is confirmed by a more recent set of pension expenditure projections produced by the EU's Economic Policy Committee, although in a less dramatic way.[6] In the latter study, the gap in public pension expenditure between social insurance and multipillar countries is around 3 percentage points. This study is based on more optimistic assumptions regarding economic growth and uses a wider definition of public pensions for some multipillar countries than its predecessor.[7] Regardless of the assumptions and the definitions, the existence of an expenditure gap in public pension expenditure between social insurance and multipillar countries is confirmed by all available data.

However, the demographic transition will not necessarily be problem-free in multipillar countries. According to conventional wisdom, fully funded pension schemes are not likely to be affected by the process of aging. Unlike pay-as-you-go pensions, these schemes do not perform intergenerational transfers. Consequently, changes in the relative size of generations are irrelevant to the financial viability of schemes. Over the last few years, however, it has become clear that, although funded pensions are less vulnerable to the direct impact of population aging, they may still be affected by it through the impact of longer life expectancy on annuity prices and the effects of demographic change on financial markets.

Pension funds allow members to accumulate capital which, depending on national regulations, can or must be converted into an annuity. The size of the annuity will depend, among other things, on the life expectancy of the relevant cohort at the time conversion takes place. Rising life expectancy at age sixty or sixty-five means smaller annuities for the same capital. In western Europe life expectancy at the age of sixty-five has increased from around fifteen years in 1950 to eighteen to nineteen years in 2000 and is expected to increase further over the next decades. According to actuarial calculations, a rise in life expectancy of four years increases the price of annuities by 18 percent.[8] Indeed, over the last few years, as a result of rising life expectancy (and falling interest rates), the price of annuities has increased in the U.K.

A less well known but potentially more serious development concerns the impact that population aging may have on financial markets in which pension funds play an important role. Traditionally, pension funds have been a major source of savings for market economies. Because they were developed essentially after World War II, they have not yet started paying out pensions on a large scale. In aggregate, across OECD countries, a majority of pension fund members are contributors, and only a minority receive a pension. This situation, however, will not last indefinitely. As the large cohorts of people born between 1945 and 1965 reach the age of retirement between 2010 and 2030, the aggregate number of retirees will exceed contributors. In order to meet their obligations, pension funds may be forced to sell off some of their assets. If they do so on a large scale, they may drive down the price of assets and lower expected returns on the invested capital and consequently decrease expected pensions.

Projections for U.S. funded pensions suggest that in aggregate the private pension system will stop being a source of savings in 2024 and will thereafter become a net dissaver. The rate of dissaving will increase more or less constantly until at least 2065 (end of the projection), when the capital outflow from the private pension system will represent about 4 percent of aggregate wages. According to the authors of the projections, this development may depress asset prices and is likely to have "profound implications for interest rates, asset prices, and the growth rate of the economy."[9]

The widely held view that fully funded pension schemes are not going to be affected by population aging needs to be qualified in the light of the above analysis. But the politics of pensions generated in the two systems are completely different. In social insurance systems, governments are likely targets for electoral punishment and informal protests because they take direct responsibility for determining benefits. In multipillar systems it is difficult to apportion responsibility for lower than expected pensions and thus to react politically. Occupational pensions may be low because of incompetent managers, wrong pension regulations adopted by previous governments, or simply bad luck.

These different political pressures generate different political responses. All four social insurance countries covered in this study legislated pension reforms during the 1990s.[10] The main objective, in all cases, was to guarantee the sustainability of public pension schemes in the face of demographic aging. In France the period over which the reference salary is calculated and the number of contribution years required for a full pension have both been extended. Thus, either benefits have been reduced for a given contribution record, or workers have been encouraged to delay retirement to maintain prereform pension rights.[11] More recently, Jospin's government introduced legislation that encouraged wage earners funds *(fonds d'épargne salariale),* which benefit from tax concessions but have a time horizon limited to ten years. Wage earners funds may turn out to be the functional equivalent of occupational pensions, depending on how employees use them.

Germany has first shifted pension indexation from gross to net wages and more recently has modified the pension formula to reduce the replacement rate gradually from the current 70 percent for a full contribution record to around 64 percent in 2030.[12] Together with these cost containment measures, Germany has also introduced provisions for fully funded private pensions, to which private sector employees can contribute tax free up to 4 percent of their earnings.

Italy and Sweden have adopted more far-reaching reforms. Italy has overhauled its very generous pension system to make it more uniform, for example by eliminating advantages for privileged civil servants, and less costly, especially by phasing out the generous provision for early retirement (*pensioni di anzianità*). The Italian reform has also changed the pension formula from defined benefits to notional defined contributions; contributions paid during the whole working life will be relevant in the calculation of benefits.[13] A shift to defined contribution notional accounts was part also of the Swedish reform.[14] In addition, in both countries the new pension formula contains parameters related to demography and the overall performance of the economy. These parameters should automatically adjust benefits downward if demographic or economic conditions are worse than expected. Finally, both countries have also introduced new legislation on private pensions. In Sweden part of the contribution to old age insurance (2.5 percent of earnings) must now be paid into a pension fund chosen by the insured person.[15] In Italy the new pension legislation encourages the creation of branch and company pension funds as well as the purchase of private pensions by individuals with tax concessions and permission to transfer the current value of employees severance payments into one of these saving vehicles. Private pensions are not compulsory and to date have developed to only a limited extent.[16]

This brief overview of reforms in social insurance countries reveals two trends. First, expenditure on public pensions is being scaled back. Second, with the possible exception of France, new funded schemes are being introduced. This reform pattern contrasts sharply with multipillar systems. Large-scale pension reforms such as these have not been common in multipillar countries. There have been some measures intended to keep the level of the basic pension low, for example, by decoupling benefit indexation from wages (since 1979 in the U.K., and on a few occasions in the 1980s in the Netherlands). In the U.K. additional reforms adopted in the 1980s have had the effect of reducing the earnings-related element of the state pension system (SERPS), a program that did not fit in with the logic of the multipillar model. The anticipation of demographic aging, however, has not generated reform as in social insurance countries. To some extent, social insurance systems are becoming more similar to multipillar systems. However, the public-private mix, for a few years at least, is going to remain largely tilted towards the former. Estimates of the impact of the new German pension legislation suggest that by 2030 workers who contribute without interruptions to the public and the private schemes will receive only 11 percent of their income from the latter.[17]

Integrating New Career Profiles in the Existing Pension Systems

Whether social insurance or multipillar, the pensions systems that were constructed during the postwar years were mostly designed to serve the typical male career profile of that period. The sort of coverage they offer is optimal for someone who has worked without interruptions, full-time, and from an early age. Today's labor mar-

Table 3 Selected Labor Market Indicators, 1970 and 1995

	Female employment rate		Part time employment		Unemployment rate	
	1970	1995	1970	1995	1970	1995
France	46.0	53.4	5.8	15.6	2.5	11.5
Germany	47.8	55.1	10.1	16.3	0.6	8.1
Italy	30.3	36.0	6.4	6.6	5.3	12.0
Sweden	58.3	68.2	20.2	23.6	1.5	7.7
Denmark	57.9	67.7	21.2	21.5	0.6	8.1
Netherlands	29.5	53.4	14.4	36.5	1.0	6.5
Switzerland	52.3	65.2	na	27.3	0.4	3.3
United Kingdom	50.2	62.2	na	22.2	2.2	8.6
Average	46.5	57.6	13.0	21.2	1.7	8.2

Source: OECD, *Statistical compendium*, CD-ROM.

kets, however, contain a much wider variety of career profiles. To a large extent, this change has been the result of the gradual but massive entry of women into labor markets since the 1960s. Very often, women's career profiles are characterized by relatively long interruptions and by part-time employment. In addition, due to the end of full employment workers are more exposed to the risk of both cyclical and long-term unemployment than in the previous generation (see Table 3). Finally, the knowledge-based economies that are emerging across OECD countries require constant skill updating and upskilling from workers who do not want to be left behind, an activity that may result in additional career interruptions.

Generally, the new career profiles will generate pension entitlements below the standard level, regardless of the institutional structure of the pension system. The growing size of the working population that is not satisfactorily covered by existing pension arrangements pressures politicians to make pension systems more inclusive. Workers with atypical career profiles may not be the most influential group in western democracies, but their numbers have been growing (see Table 3) and probably represent an interesting target constituency for political entrepreneurs seeking electoral support. In addition, improvement of pension coverage for atypical workers provides a rare opportunity to take credit in the field of social policy.[18]

Governments can be expected to be under pressure to improve pension coverage for nonstandard employment. The measures they are likely to adopt, however, vary substantially depending on the kind of pension system in place. In social insurance systems, extending the quality of pension coverage for atypical workers takes the shape of contribution credits that are attributed to pension accounts during periods of inactivity, especially in relation to child bearing. In multipillar pensions systems this same social development puts pressure on governments (or on the social partners where relevant) to increase the coverage of second pillar pensions to include a larger proportion of nonstandard employment.

By the late 1990s virtually all social insurance countries had introduced contribution credits for carers and other inactive individuals. Sweden grants contribution credits for having children, periods of unemployment, and sickness. With regard to children, if a parent reduces working hours in the four years following the birth of a child, contributions are credited to his or her pension account on the basis of previous earnings.[19] In Germany parents are entitled to contribution credits equal to those payable on an average wage for each child under the age of three living in the same household.[20] In Italy pension contributions are credited for periods of inactivity due to maternity leave (five months) or parental leave (ten months), sickness or accident (twelve months), unemployment, and military service. Parents can also claim contribution credits for short periods of time spent caring for a sick child.[21]

Multipillar pension systems deal with atypical employment in a differentiated manner. Usually, their first pillars do not penalize part-time workers or people whose career is punctuated by interruptions. Whether entitlement is residence-based (Denmark, the Netherlands) or contributory (U.K., Switzerland), a drop in income resulting, for example, from working reduced hours does not affect the level of the benefit, which is flat-rate in these countries (nearly flat-rate in Switzerland). Similarly, career interruptions due to child rearing, education, unemployment, and sickness do not generally have an impact on the amount of the basic pension. Where they do, the impact is generally less than proportional to the time spent out of the labor market. Overall, the basic pensions found in multipillar pension systems guarantee a reasonably good coverage for the new career profiles that have been developing over the last few decades, but they do so at a rather low level. In the Netherlands and in Switzerland the basic pension replaces 40 and 35 percent of the average wage, respectively; in Britain the same figure is below 20 percent, while in Denmark it reaches 31 percent (including the ATP supplement). The replacement income guaranteed by public pensions in multipillar systems is most likely below most workers' expectations.

Things are rather different as far as the second pillar is concerned (or third pillar labor market pensions for Denmark). Here, because of the limited extent of risk pooling (an economic sector or company), the sort of corrections adopted in social insurance pensions and in first pillar schemes are unlikely. Contribution credits granted for career interruptions would have to be financed by other scheme members and would be particularly difficult to implement in precisely those sectors of industry in which they would be mostly needed, essentially those with a high proportion of female staff and those exposed to cyclical unemployment and to disability and sickness risks. As a matter of fact, the pension funds in the four multipillar countries covered in this study do not grant contribution credits for career interruptions. In general, as a result of the absence of contribution credits, pension fund members will have to face the full cost of career interruptions and reduced hours (unless future earnings allow them to catch up through additional savings).

Since contribution credits are not an available option in these pension systems, the emergence of new atypical career profiles generates a different set of pressures and political demands, essentially, to expand the coverage of second pillar pensions. Expanded coverage may not compensate for periods of inactivity but can improve the extent to which part-time and temporary work generates pension entitlements. The way in which second pillar pension coverage is improved varies across countries and depends on the extent to which the state is involved in regulating access to second pillar pensions.

In Denmark, where occupational pension coverage is not mandatory, its expansion has been achieved through a series of collectively negotiated agreements that have increased coverage to 80 percent of private sector employment in 1996.[22] Denmark has long been an exception in western Europe for not providing compulsory or generalized earnings-related pension coverage. In fact, the Danish second pillar (ATP) delivers modest flat-rate benefits, and occupational pension coverage was limited throughout most of the postwar years. During the 1980s, however, it became clear that the Danish pension system was producing substantial inequalities in retirement provision between those who had access to occupational pensions and those who did not. As a result, the trade unions campaigned for an extension of supplementary pension coverage by requesting the introduction of a central pension fund, available to all employees and managed by the unions. The proposal met with little enthusiasm from other political actors; only in 1991 was pension coverage expanded. However, expansion was not the result of new legislation but of a collective agreement signed by the industrial workers union, which included generalized supplementary pension coverage. Other trade unions introduced similar schemes, dramatically expanding pension coverage.[23]

In the Netherlands, a country where part-time employment has soared over the last two decades (see Table 3), the coverage of occupational pensions has recently been a key issue in pension policy. As a result of social partners' efforts, occupational pension coverage has increased from around 80 percent of employees in the 1980s to 91 percent in the late 1990s.[24] In 1997 an agreement between the social partners and the government included the objective of further increasing the coverage rate. Those not covered by a second pillar pension either are employees of employers who do not offer a pension fund (2 percent of cases) or are excluded from coverage by the funds' rules. These rules can provide coverage only to employees who are older than twenty-five, are hired on a permanent contract, or have earnings above a given threshold.[25] Other reforms have concerned such aspects as freedom of choice for scheme members and improvement of pension funds investment performance.

In Switzerland the issue of expanding coverage, currently at about 90 percent of employees, is also high on the agenda. Membership in a pension fund is mandatory only for employees earning above approximately 37 percent of average earnings, a threshold generally exceeded by full-time workers but not by many part-time employees, most of whom are women. The trade unions and the Social Democrats have been campaigning for the removal or the reduction of the earnings threshold, but so far employers and right-of-center parties have successfully opposed the move.

In the U.K. policies aimed at improving pension coverage for low income workers have also been adopted in the 1990s. The issue became particularly pressing after the 1986 pension reform, which reduced the level of the state second pillar pension (SERPS) that provided a supplementary pension to those who did not have access to occupational coverage. Many workers bought private pensions and found afterwards that this sort of pension coverage was not suitable for their low earnings. Additionally, the high administrative charges of a private pension can swallow a good proportion of the contributions paid by a low income individual. In order to improve coverage for the low paid, the Blair government has turned the state earnings-related scheme into a flat-rate pension designed to cover workers with very low average earnings and interrupted careers (state second pension). For those with low earnings, the new flat-rate benefit will be higher than the equivalent earnings-related pension. For workers with moderate earnings who do not have access to an occupational pension, the government has introduced a new quality label (stakeholder pension) that is given to personal pensions that meet certain criteria. Administrative charges for any individual account can not amount to more than 1 percent of assets; there can be no penalties for contribution interruptions; and schemes must be governed by a trust.[26]

As with population aging, labor market changes generate different political demands and policy responses in each of the two worlds of pension provision: contribution credits in social insurance countries and the expansion of occupational pension coverage in multipillar systems. These two measures, however, are only partial functional equivalents. In fact, individuals who spend time out of the labor market to care for children are probably best served in social insurance countries, where contribution credits compensate for this form of nonmarket work. The second pillar component of multipillar systems does not similarly compensate such individuals.

Financial Market Integration

There has been an unprecedented movement towards an ever stronger integration of international financial markets in the last three decades. This movement has occurred globally, with the gradual removal of restrictions on capital movements and the liberalization of the provision of financial services in a large number of countries. It has occurred to an even larger extent in western Europe and particularly within the European Union with the establishment of the freedom of movement for capital and the adoption of a single currency. Our concern here is limited to the implications of this development for pension policy. The shape of a pension system, in fact, can influence the position of a country in the international financial system in a number of ways.

First, with the increased mobility of capital, investors are better able to move their funds to countries where they believe they can obtain the highest posttax profits. This development has been widely interpreted as a limitation on countries' ability to tax domestic economic activities. Social insurance pension systems are financed essentially by a tax on labor (social contributions), and in this respect they are directly dependent on governments' ability to raise such taxes. If the level of social insurance contributions is perceived as being too high by international (and domestic) investors, they may decide to move their activities to another country. Of course, countries that have high social contributions tend to have the most productive work forces in the world (France, Germany). However, if the contribution increases needed to finance pensions for an aging population are not matched by corresponding increases in labor productivity, then higher contributions may result in lower profits for investors and possibly in capital outflows.

In contrast, multipillar pension systems are financed from two different sources: taxation/contributions and the profits of those industries in which pension funds' assets are invested. In this respect, the reliance of these systems on the ability of governments to raise taxes is less pronounced. Moreover, the same development, a globalization-induced pressure to maximize profits, that may constitute a source of problems for social insurance systems but may be an advantage for multipillar systems whose pension funds are among those actors who will benefit from an increase in corporate profits.

In addition, a large funded pension sector may constitute an advantage for an economy that is fully integrated in international financial markets. Countries with multipillar pension systems have different rules concerning where and how pension schemes can invest their funds. They vary from the prudent person rule applied in the U.K. and the Netherlands to a more directive approach that sets limits on different types of investment in Denmark and Switzerland. However, regardless of the rules in force, pension managers tend to invest a substantial part of their funds in assets denominated in the same currency as the one in which the payments must be made. This procedure is known as currency matching and is designed to protect pension funds from excessive exposure to exchange rate risks.

The proportion of assets that are matched to the domestic currency varies from country to country. In Denmark and Switzerland the law prescribes that pension funds can not hold more than 20 and 30 percent of their assets, respectively, abroad, although, as shown in Table 4, actual holdings of foreign assets are well below these limits.[27] In countries that do not regulate pension funds investment policy with quantitative limits, the proportion of foreign assets is somewhat higher (the Netherlands,

Table 4 Foreign Assets Held by Pension Funds as a Percent of Total Assets, 1998

Denmark	8
Netherlands	29
Switzerland	12
United Kingdom	28

Source: European Commission, *Proposal for a Directive on the activities of institutions for occupational retirement provision*, (Brussels: COM (2000)507, 2000), Annex 7.

U.K.). Over two-thirds of assets, however, are invested domestically. Because pension funds tend to invest domestically, countries with a large funded pension sector have at their disposal a de facto source of captive capital that is likely to support the domestic stock market and companies in general and to some extent to protect them from full exposure to truly internationalized financial markets.

This sort of reasoning may be behind recent EU policy on pension funds. Over the last few years the European Commission has taken a number of steps towards setting up a regulatory framework for private pensions, which has culminated with the adoption of a directive proposal in October 2000. The memorandum that accompanies the proposal spells out the reasons that pushed the Commission to take action in this field. In addition to protecting pensioners' living standards, it is stated that a regulatory framework is needed because pension funds "play a key role in financing Europe's economy and in the operation of the Union's capital markets" and they "contribute to the increase of the stock market capitalisation, which is still about half of that of the United States."[28]

Obviously, the advent of the single currency creates a major opportunity for pension funds to contribute to the expansion of Europe's financial markets. Foreign investment for funds is now possible throughout the Euro zone, without exchange rate risk. However, the limits on the proportion of foreign assets imposed by the national legislation in many member states will considerably limit the ability of pension funds to contribute to this development. As a result, one of the key objectives of the directive is to remove the quantitative investment restriction that exists in some member states.

From the point of view of this third challenge, multipillar pension systems do not need to change their policies. In contrast, social insurance countries are under pressure from employers and investors to create a funded pension sector so that more capital will be available to finance domestic production. Again, reform trajectories in each of the two worlds follow from the pressures. In particular, with the exception of France, all the social insurance countries covered in this study have taken steps towards expanding (or developing) a funded pension sector. The size of change in this direction is probably not so impressive, but its political and potential long-term implications could by enormous. The planned reduction in social insurance pension benefits, plus other possible cuts in future years, may push current workers into the new funded arrangements that are being set up.[29] Such a phenomenon occurred in the U.K. in the 1980s. When Thatcher made it possible for employees to opt out of the state second pillar system to buy a personal pension, some 5 million workers took the opportunity, against a government forecast of 500,000.[30] France, where pension funds remain unpopular, seems to be an exception in this respect. The recently introduced wage earners' funds may nonetheless constitute a functional equivalent to pension funds in so far as the provision of investment capital to domestic producers is concerned.

Conclusion

Most of the current debate on pension reform focuses on the adaptation of pension systems to population aging. This challenge, however, is not alone in influencing the direction of pension policy. Together with the impact of aging, governments need to deal with the demands that new forms of employment put on pension systems and with the requirements of an internationalized capital market. To fully understand the direction taken in pension reform, one must refer to developments in each of these three areas. This perspective, for example, can account for the fact that many reforms have combined overall benefit reductions with improvements for some groups of the population, generally individuals performing nonmarket work.

The way in which individual countries respond to these challenges varies and seems to be related to the structure of their pension systems. In relation to the first set of pressures, those related to population aging, policymakers in social insurance countries face the dilemma of choosing between two equally politically risky solutions: either to increase contributions for current workers or to decrease pension benefits. The dilemma has been solved, in at least three of the four countries covered by this study, by cutting future public pension benefits and compensating for the cuts with new privately funded pensions. Governments have thus contained the expected increase in public pension expenditure and at the same time continued to promise current overall benefit levels in the future (with public and private benefits). The fact that the cuts in public schemes will be compensated through the benefits paid by the new private or occupational pensions was a key element in the Swedish and in the German reforms and to a lesser extent in the Italian.

The dilemma of whether to increase contributions or reduce benefits does not take on the same significance in multipillar countries, as either of the two options is politically easier to implement. Insofar as funded pensions are concerned, contribution increases are unlikely to be perceived as an additional tax. They are needed to secure better pensions for the very same individuals from whom they are requested.

In these systems there is a direct link between what an individual pays in and what he or she will receive from a pension fund. In addition, lower benefits do not need to be the result of political decisions. They will either occur automatically, simply as a result of market underperformance, or will need to be enforced by the governing bodies of pension funds. In either case, governments are less likely to be held responsible for lower than expected pensions.

The situation is almost reversed in relation to the second challenge identified in this article: adapting pension systems to new forms of employment. In this case it is technically relatively easy to introduce corrective mechanisms in social insurance schemes, in the shape of contribution credits. In multipillar systems, in contrast, governments and the social partners are dealing with the issue by expanding occupational pension coverage, a strategy that will not reach individuals who are performing full-time nonmarket work and that is unlikely to result in the inclusion of all relevant workers. In these countries it is possible that pressure to improve coverage for nonstandard employment will remain for some time.

Multipillar systems, finally, seem to be better suited to today's highly integrated capital market. They do not rely exclusively on domestic labor to finance pensions and provide a source of investment capital to the national or currency area economy. In this respect the pressure is on social insurance systems to build a funded pension sector.

This set of pressures as mediated by national institutional structures results in a mix of convergent developments and in the persistence of national differences. Convergence is seen in relation to the first and the third challenge (population aging and financial market integration), and the direction of convergence is clearly towards the multipillar end of the spectrum. In contrast, in relation to the second challenge (adapting to a changing labor market) the two worlds are developing distinctive solutions that keep them on different policy tracks. Even though social insurance systems are moving in the direction of multipillar systems, they are doing so at a rather slow pace and not in all areas. The result may be the emergence of two different types of multipillar systems, one of them consisting of reformed social insurance systems that will contain a small private pension supplement. Chances are that the policy decisions taken some one hundred years ago will continue to matter for a while.

NOTES

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