Introduction

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This book is about change in the political economy of pensions, what type of change took place, why and how it was realized and which outcome may be expected for the future. The chapters provide a detailed review of recent pension reforms in several countries, and offer institutional evidence of the extent to which these reforms suggest there has been something of a rethinking of the directions of the welfare state and, more specifically, whether the rethinking has taken the form of changing the public–private mix of policies. We have cast a wide net covering the experience of 15 western countries that have in the past decade or so launched a significant redirection of pension policy. The countries were selected to represent something of the great variety of new directions that mature industrial economies as well as economies in transition have taken. Two essays in this volume seek to provide a quantitative empirical foundation for examining the extent to which a change in the mix is evident in the income package of aged households. Finally, several chapters provide an overview of regional developments and emerging new patterns.

The question that we want to explore in this introduction is whether there are some general conclusions that can be drawn from the essays in this book. Is the thesis about change in the political economy of pension reform leading to new forms of the public–private mix justified? What are the general trends that have emerged from the reports presented in this volume? We propose five general themes. These are not exhaustive and they do not capture the subtle and detailed accounts presented in the country chapters. But our intention is to be selective in order to highlight what are the most important conclusions of this inquiry. The themes are interdependent rather than free-standing. The developments sketched out in each theme then proceed to influence the analysis in the following theme, forming something like an interlocking mosaic.

OVERLAPPING MODELS OF PENSION SYSTEMS

Traditional approaches to developing typologies of different welfare state regimes have assumed that it is possible to develop a classification of types that characterize the welfare state viewed as a whole embracing all the stages of the life course. Such schemes are assumed to be stable over time. Theories of path dependency seem to justify the assumption of relative stability, on the assumption that, once a pathway has been chosen, it is hard to reverse directions in any significant way that signals a shift in the underlying paradigm implied in the typology.

We believe that the evidence in the essays presented in this book suggest quite different general conclusions. We do not see examples of clear, unambiguous models of type A, B or C in the retirement domain that is the focus of this study. What emerges is hybrid forms rather than pure types. And if this conclusion is valid within a specific domain like retirement policy then it is hard to imagine that uniform patterns over the whole welfare state are faithful to the regime type that is posited.

Instead of focusing on stable, relatively unchanging and uniform types, we see a pattern of sequencing, changes in direction over time.[1] A specific form of overlapping models can be seen in particular in some of the countries in transition which implemented quite different new pension schemes compared to the already existing schemes. Here, different models are operating and sometimes covering identical persons. In most of the countries that we review in this book public sector pensions are available universally to virtually the entire population. But public schemes are under severe pressure in many countries. On the other hand, a feature of new pension policy initiatives is that in many countries there is a trend towards extending coverage in the private sector to the working-age population as a whole and by this changing the public–private mix in pension policy and in income packaging in the future.

THE MOVE TOWARD EXTENDING COVERAGE OF PRIVATE SECTOR PENSIONS

There has been a longstanding recognition that voluntary pensions in general as well as those sponsored by employers have the shortcoming that they only cover a segment of the working-age population. But the movement towards extending coverage of private sector schemes has emerged not only from several quite different and somewhat unexpected directions. Here we try only to bring together these disparate threads that are discussed in more detail in country chapters of this book.

Perhaps the earliest development was in the Netherlands, when, shortly after the Second World War, in 1946, legislation was passed which recognized that an adequate pension system requires the combination of a strong public system together with quasi-mandated private occupational pensions (see Chapter 5 of this book). So the Dutch started with a commitment, not to public dominance, but to a public–private mix. Over the years since the inception of this legislation occupational pension coverage grew to 90 per cent of the employed population. Then, in 1998, the government created a Pension Covenant, requesting that the private sector modernize its operation and lower the public franchise which is the method used for deciding the size of the public contribution to a consensually agreement replacement rate of 70 per cent of final wages. But then it also insisted that efforts be made to fill the 10 per cent gap in coverage and insisted on the development of additional schemes that would include the whole labour market. If the social partners could not reach an agreement, the government threatened to pass legislation that would ensure that these goals would be realized. So a new Covenant was created in 2002 to continue the pressure to realize this and other objectives. In the context of this discussion, the aim of universal coverage of occupational pensions is perhaps also based on the assumption that such a goal would also lower public pension costs in the long run, since the public–private schemes are tightly coupled, and a stronger private sector implies lower benefits in the public sector.

Another recent example of expanding private coverage and benefit levels came, surprisingly, from the Swedish pension reform of 1994 (see Chapter 8 of this book). Even though coverage in the Swedish occupational pension system is very extensive, the value of these pensions is relatively low, accounting for perhaps 10 per cent of the income package of aged households. The legislation called for the mandating of capital funding schemes in the market by setting aside 2.5 per cent of compulsory contributions for this purpose. Thus everyone receiving a public statutory pension system at the same time is enrolled in an individual financial accounts system. The collection and management of the contributions is organized by the public sector and the funds are then anonymously invested in a plan that is chosen by the worker. The managers of these plans do not know the identity of the investor, so this is clearly a public statutory programme with capital funds managed by the private sector.[2]

A very different pattern of extending coverage has its origin, not in the efforts to reform the pension system, but in the initiative of reforms introduced in the industrial relationship system of wage negotiations. The crucial assumption in these reforms is that an occupational pension is interpreted as being broadly equivalent to a postponed salary. Accepting this assumption, it follows that unions and employees would be willing to accept wage restraint and, in exchange for these deferred wages, an employment-provided pension benefit. This may support government policy in periods of an overheated economy. In Australia, the labour market tribunal refused to extend these labour agreements, since compliance with the agreements was weak and many firms failed to provide the pensions. As a result, the state decided to make the system mandatory and to use the power of taxation to impose uniform coverage. Over 80 per cent of wage and salary workers are covered by the legislation (see Chapter 3). A similar development occurred at very nearly the same time in the wage negotiations of 1991 in Denmark. In this situation public, mandatory statutory legislation was not necessary since in Denmark unionization was very strong. Most people over their lifetime will find themselves in jobs covered by collective contracts, hence this programme is referred to as one of labour market pensions.[3]

A similar expansion of coverage occurred when Switzerland mandated occupational pensions, but for very different reasons than that these developments occurred in the other countries. In part the expansion of the private sector by mandating was inspired by the fear that a referendum calling for an expansion of public pensions could be transformed into a legislative programme. Private mandating was designed to offset this development (see Chapter 4).

Taken together, these various developments have all contributed both to the extension of coverage and to increasing the value of these private occupational pensions. At the same time, the expansion of coverage has in some countries led to the partial substitution of private for public provision, a theme we discuss next.

SUBSTITUTION OF PRIVATE FOR PUBLIC

In the traditional employer-provided and financed occupational pension (discussed next) the relationship between public and private pension provision was based on the principle of supplementation. This meant that the private was paid on top of the public pension, whether the public system was resident-based and uniform or an earnings-related system. The exceptions to this generalization were discussed above, where we tried to show that, in those countries that introduced a transfer test as a condition for the receipt of a public pension, the principle of supplementation did not fully apply. Even here there were exceptions if, for example, rules for ensuring a minimum public guarantee were developed or a very high taper test was introduced so that the transfer test did not affect the benefit received from both systems.

But, in this section, we discern a new emerging pattern of substituting private for public pensions. The new design based on the principle of substitutions was introduced in the German pension reform of 2001, in the Swedish 1994 reform, and in the American debate about pension reform introduced by the President's Commission to Strengthen Social Security final report submitted in December 2001. The Swedish pension reform of 1994 created two defined contribution plans: a notional and a financial plan based on contributions made on lifetime earnings, an implicit rate of return more or less equal to per capita wage changes during the phase of lifetime savings, followed by an annuity based on life expectancy at retirement (see Chapter 8). A small part of the contributions made to public pension, 2.5 per cent of the total 16.5 per cent, was reassigned in the financial plan, so that individuals could create personal investment accounts in market equities with the freedom to select and invest in a plan of their choice. But the full implications of these market-driven investments are only evident when the changes in the contractual employer-provided supplementary pensions are considered. Sweden has an elaborate system of occupational pensions covering 90 per cent of the employed population. The Swedish contractual schemes are organized along four corporativist lines: white-collar, blue-collar, municipal and central government workers. These contractual schemes add about 10 per cent to the basic public pension.

The public pension reform (notional defined contribution, NDC) and the introduction of financial defined contribution (FDC) have led to the redefining of the role of private occupational pensions so that they can be better integrated into the new scheme based on lifetime earnings and defined contributions. But the contributions to these funds will be augmented in varying amounts from 2 to 4.5 per cent. The implications of this new scheme for pension replacement rates are very dramatic. They could lead to the substitution of private for public funding. The private contractual scheme, especially when it is placed in concert with the public FDC, would appear to be able not only to offset the decline in the value of the public pension system, but also to usher in an era where this combination of a public–private mix can come to dominate the Swedish pension scene. Perhaps this is an exaggeration for the population as a whole, but it may very well play an increasing role for many segments of the labour force, apart from those in the very highest income brackets.

Sweden has also moved towards investing the funds accumulated in collective investment buffer funds in a broader range of instruments than the traditional low-risk and low-return strategies relied on in the past. Kent Weaver's essay in this volume explores the Swedish experience with buffer funds, with a focus on the governance structure of default funds, which is the fund that accumulates the resources of those who do not make an active fund choice. He compares the politics of investing collective buffer funds in Sweden with that of a number of other countries, thus opening a new research agenda for the comparative study of public–private pensions.

Germany too is now changing the public–private mix through the reform of 2001 (see Chapter 6). The reform measures aim at a decline in public earnings-related pensions and to offset this by an increase of voluntary private or occupational pensions with tax incentives. Private pensions are even used as an instrument to reduce public pensions by introducing a notional contribution rate for private pensions into the formula for calculating public pensions. If employees are voluntarily saving in addition for old age, this leaves the retired person with about the same level of protection but with a partial substitution of private for public benefits.

If we accept the line of reasoning developed above, the reform in Sweden as well as in Germany see private pensions, not as an 'add-on', or a supplementary system, but one that 'carves out' a private segment that is designed to substitute for the decline in the public pension system. Thus the German voluntary private pension and the Swedish FDC share a strategy of carving out a private component to offset a faltering public system. In the United States, the substitution of private for public benefits will depend on whether the president proposes new legislation, on which plans are proposed in the legislation and on what action Congress might take in response. The details of these plans are reviewed by Friedman in Chapter 7.

'Contracting out and contracting in' is yet another way of substituting private for public provision. Several countries have encouraged with tax incentives, or simply permitted, the reduction of the public sector by a process of allowing individuals to contract out of the public system into an approved private plan that provides benefits and protection at least as good as that provided in the public sector. As Schmähl points out, such practice may actually occur in countries where one would least expect to find it. For example, in Germany, employees working in firms of professional groups of self-employed, for example medical doctors with an independent practice, architects or lawyers, can contract out of the public pension system. For all employees a special new scheme for a partial contracting out has been implemented in Germany, whereby employees gain the right to convert part of their earnings into an occupational pension. One of the possible ways of generating earnings for investment in the market is exempting the earning from both payment of tax and social insurance contributions. Thus the employer is not totally contracted out of the public scheme, but only that portion of the earning that would have been subject to tax and social security contributions.

On the other hand, there are at least two countries where contracting out is quite widespread: the United Kingdom and Japan. The essays in this volume (by Blake and Katsumata) describe the practice, and comment on some of the differences, in the two countries. In the UK contracting out is a widespread practice. Only about 15 per cent of wage and salary workers, mostly low wage workers, are in the earnings-related public statutory programme known as SERPS. Britain encouraged the practice, first into employer provide pensions, and then through tax subsidies that individuals switch to individual accounts. The government considered altogether eliminating the public social security programme but in the end decided against this radical action.

The development in Japan is particularly interesting. As firms fell on hard times with the economic recession, those that had contracted out of the public scheme found that they could not honour their commitments. The government, having required contracted-out firms to assume a rate of return on investments of 5 per cent, then lowered expectations to 2.5 per cent, but the actual rate of return was closer to zero. Under these persistent conditions, firms' pension systems will go bankrupt. To protect themselves, corporate pressure groups emerged which sought to convince the government to change the legislation and permit firms to contract back into the state programmes on favourable terms.

Such a contracting in was also allowed in the new Hungarian pension system introducing a mandatory funded pension scheme as second tier of the pension system. As the expected development in the new scheme was not forthcoming, contributors were offered the possibility to cancel their decision to join the new scheme.

What, then, are the long-term consequences of these different patterns that we have described: extending coverage of private pensions, the substitution of private for public, and the transition of employer-provided and financed pensions, at the same time introducing the flexibility of contracting out as well as moving in the opposite direction of contracting in? Of course, prediction is always difficult, but still some general conclusions seem beyond question. Instead of viewing the question as one of 'either or', it seems best to focus on the principle of 'both and'. The question that then emerged was to agree on what share of total income is to be provided from the contribution of both the public and the private spheres and what proportion of this total should come from each sector. But not all income groups have a public–private mix in the income package of aged households. Will the trends that we have described become dominant? That is, will wider shares of coverage in the private sector be accompanied by declining shares of the public sector? Partly the outcome will depend on the mechanisms that produce it. We have identified a wide range or mechanisms. The outcome could be brought about by the introduction of transfer testing in the basic public system; the tight harmonizing of public and private resources against a target replacement rate; the carving out of a portion of the public statutory pension for a mandatory investment in capital funds; encouragement of the carving out with a voluntary system with tax incentives; an additional consideration should the system be designed is to permit the individual to contract back into the public sector at some later point in time, as the British opted to do. Still other approaches may emerge, since the list is by no means exhaustive. As always, the devil is in the details of the mechanism that produces the outcomes.

There seems to be an overall development towards a closer contribution–benefit link. This can be realized in different ways:

- redesigning public defined benefit schemes, reducing intertemporal redistributive effects, extending the years of insurance taken into account for benefit calculation, financing interpersonal redistribution by tax instead of contribution revenue;
- introducing notional defined contribution schemes;
- shifting employer-provided occupational pensions from defined benefit to defined contribution plans;
- shifting from public to private pensions.

This is to be seen as a trend not only in mature Western pension schemes but also in many of the countries in transition (see Chapter 11).

PERSISTENCE OF THE PUBLIC PENSION SYSTEM AND THE CONTINUOUS EVOLUTION OF THE PUBLIC–PRIVATE MIX

When we turn to the economies in transition it is obvious that the monopoly of public provided pensions is changing towards more diversity. There is good evidence in Poland (see Chapter 12) as well as in Hungary (see Chapter 13) that the systems are still evolving. The discussion of the pension system can shape the public–private mix in the pension system that is now implemented, when experience will have been made with its effects. During the process of transforming pension schemes the disparity between plans which set the ambitions of legislative intentions and practice which defines what actually happens on the ground became obvious. So reform leads to a process of continuous sequence of events whose direction remains uncertain.

Rutkowski (in Chapter 11) tries to locate the Polish and Hungarian development in the broader context of the actual experience of most transition economies. He also considers the development of the proposals for reform made by the World Bank that have emerged from the experience of the 1990s. The diversity of country conditions was more and more recognized and influenced the approach the bank was proposing in various countries for radical reform. The World Bank was an influential and perhaps even a key actor in many countries that promoted the idea of the substitution of private for public provision. Müller (in Chapter 14) tries to associate the experience of transition economies in Europe with developments in Latin America, as the reforms made there were studied carefully in many countries in Central and Eastern Europe.

Of course the economies in transition in Central and Eastern Europe never had a developed private sphere, so any expansion of this sphere represents to some extent a substitution. But the question here is whether there has been an evolution towards private dominance, as in some Latin American countries. As the essays in this book clearly demonstrate, in Central and Eastern Europe a more or less full-scale replacement of public by private pensions has not taken place. Public pensions still predominate, but there is a continuously changing public–private mix. The new funded elements are far from mature. Their part in creating future pension benefits will increase over time. What the mix in retirement income from public and private schemes will be in the future we cannot tell.

TRADITIONAL EMPLOYER-PROVIDED PENSIONS IN TRANSITION

A simple meaning of traditional private employer-provided pension systems would be that of an employer who pays for, and provides a defined benefit for all employees who are eligible, in a fully funded pension programme whose main parameters were designed by the employer alone to address his need to attract, retain and motivate his employees. This simple scheme of pay, provide and decide is not a caricature, but a description of the private pension system offered by many large employers. Of course, many smaller firms do not directly provide, but delegate the administrative tasks to life insurance companies or to pension funds that administer several smaller schemes together, to benefit from economies of scale. But this account of the meaning of private does not imply that the public sector is absent from any active involvement. Besides its role as an employer, the state conventionally plays two traditional roles: it provides tax incentives and perhaps direct subsidies to pension plans to encourage the creation of plans that supplement the benefit levels provided under the public social security programme, and it also plays a regulatory role in protecting the money of contributors, preventing theft and the flagrant disregard of the conditions that were set in return for the resources offered to these tax qualified plans.

This model of employer-provided defined contributions, with the employer financing the scheme and bearing the risks of paying for the system when benefits are due, is almost everywhere in transition. The transition takes many forms, but the clearest moves are in the direction of introducing defined contribution plans, largely financed by the employee, but with employer contributions in some schemes. The transition can take several different forms: voluntary individual accounts based on personal savings schemes with the individual paying for the accounts alone or with the help of the employers. In the United States, 401 (k)[4] plans take both these forms. But they can take the Danish form of a combination of forced savings and contractual labour agreements that provide defined contributions financed by deferred wages. They can also take the form of the 'carve-out' arrangements described above. We identify the transition and leave open the multiple pathways to move away from the voluntary agreements on traditional defined benefit employer-provided and -financed plans.

A note of caution should be sounded here. Despite the shift in new plans, employer-provided benefits may continue to rise for some time as generous plans introduced in the past will reach maturity in the present. So once time lags that are important in particular for old-age security are taken in account, there can still be a rise in the importance of traditional plans as a source of retirement income with the plans themselves in the process of transition.

CONSEQUENCES OF THE EMERGING PATTERNS

If we allow for the twin outcomes of broader coverage and substitution of private for public at least in mature welfare states, what might we expect as a plausible emerging pattern? There are two possibilities. One scenario is the growth of inequalities among the aged, on the assumption that private pensions are more likely to be found among higher-income groups which also benefit more from tax expenditure and other subsidies. In contrast to public schemes, private schemes have no elements aiming at a reduction of income inequality in old age. The evidence to support this claim is strong (see Casey and Yamada in Chapter 15). But at the same time, if the focus is on the total pension income from both sources it may not be the mix per se that is crucial, but how the mix is designed. Some countries with high mix, such as Sweden, Denmark, Norway, Holland, Switzerland and Canada, have both low poverty rates and relatively low inequality. On the other hand, countries like the UK and the USA have both high poverty and high inequality. Design rather than the mix might in the end turn out to be the more decisive factor in determining the wellbeing of people in retirement (see Chapter 16). To identify properly the emerging patterns in income mix as well as regarding inequality, a cohort-specific approach is needed, based on longitudinal data.

AMBIGUITIES IN THE CONCEPT OF PUBLIC AND PRIVATE

Now that we have developed our ideas about the recurrent themes that characterize recent pension reforms, we want to discuss some definitional issues about the meaning of a public–private divide and the extent to which quantitative data can help clarify these issues, or whether these issues must be resolved before empirical data can be usefully employed.

We have used the terms ‘public’ and ‘private’ throughout this discussion without calling attention to the blurring of the concepts and the substantial ambiguities surrounding these ideas. So it is important to make some of these difficulties more explicit. Nevertheless, this is not an argument for not using these concepts, but for recognizing that they are fuzzy. Fuzzy concepts play an important role in public policy debates, as witnessed by the widespread use of ideas such as sustainability or generational equity. But still it is useful to recognize and to identify some of the sources of the fuzziness.

The effects of the public–private mix on the economic wellbeing of the aged are difficult to pin down empirically. Some reasons for these difficulties warrant a brief discussion. As pensions systems have evolved over time it has become increasingly difficult to draw a clear and unambiguous boundary between public and private. The first complication arises because the state has a dual role as general provider of public social security programmes and as employer. These are two quite different roles. The state can establish its own employer-provided programme, for the same reasons that the private sector will establish supplementary pensions to the general public schemes.

The second complication involves, not a definitional change, but a change in practice. This change occurred in 2002 in Japan, with employees being able to opt out of the public sector pension into a private occupational pension. Japan and the UK have this possibility of officially contracting out of the public sphere and making private pension arrangements. In Japan, firms viewed the privatization of public pensions as an economic opportunity and they lobbied the government to facilitate the process of transition into private occupational pensions. The government established a condition for the transition, namely that the scheme had to be funded based on the assumption of a 5 per cent minimum rate of return on equity investments. This was attractive when the return rates were more than double this amount, but when there was an economic turnabout firms had a zero rate of return. In this new economic climate firms lobbied for a political change in legislation, passed in 2001, which makes it possible for firms to ‘opt into’ the public system. Although the process of transition took many years to achieve, this change from ‘opting out’ to ‘opting in’ of course also meant a change in the public–private mix (for details see Katsumata in Chapter 2).

The third complication concerns emerging practice, where a part of the public system is 'carved out' of the public statutory system and this separated portion is funded by direct investments in the equity market. In Germany, the carved out segment of the public pension is private and voluntary, although this may change in the future.

In Sweden, the carved out section of the public programme, which is called the premium pension, is a hybrid form since this is partly a public programme as the public sector handles the transfer of money to the equities market and the gains or losses in the financial account chosen by the individual reverts to them as a private investment. The investments are based on choices made by the individual with resources derived from the public contributory social insurance programme. The public component of this system is that of a notional account, since the money is not actually invested, but it is an accounting system which is only converted to actual resources at the time of retirement, whereas in the premium pension system, hard currency is actually invested in the market. (See the Swedish and German cases in this book.)

The fourth complication is that the use of the term 'private' does not imply that the public sector is totally absent from any active involvement. The state conventionally plays two traditional roles: it provides tax incentives and perhaps direct subsidies to pension plans to encourage the creation of plans that supplement the benefit levels provided in the public social security programme and to protect its investment; it also plays a regulatory role to insure compliance with the agreed upon rules for managing the system, to prevent direct theft or flagrant disregard of the agreed upon rules and norms of appropriate behaviour. In 1995, the Dutch Civil servant pension system was privatized, meaning that it was subject to the same set of regulations that private sector pensions were required to comply with. So we have a public agency defined as a 'private' agent. Many countries have such supplementary public sector pensions which are treated as private systems supplementing the general public social security programme. There is no completely satisfactory way to resolve these definitional questions (see Chapter 5). This note of caution regarding the fuzzy boundaries that demarcate our subject may be useful if it can cure the tendency to say more than what the data suggest.

NOTES

1. Some analysts will concede the point about divergent paths, but still insist that there is nevertheless a common dimension in all the Nordic countries which is the unique model of a commitment to full coverage, universalism and to the principle of solidarity that justifies its having a unique Nordic commitment.

2. As early as 1960, Finland also created a hybrid earnings-related public statutory system that was partially funded but managed by private sector investors in conformity with tight public regulations. The basic public pension system is transfer-tested, so the larger the earning-related system, the lower the basic, uniform pension. Thus over time and over the income distribution, as this hybrid public–private system matures, the lower the level of aggregate public spending for the resident-based, flat rate public pension financed from general taxation. This, of course, follows a different logic than the Swedish financial accounts, but the Finnish design does involve the extension of coverage into the privately managed pension system by a public statutory programme with near universal coverage.
3. In Denmark, the public supplementary pension will decline as the labour market pensions grow, because these pensions are transfer-tested against the public scheme. In Australia, the nature of the relationship between the mandatory pension and the public means-tested programme has not yet been agreed upon. In Sweden and the Netherlands, coverage by the private occupational pension, which has traditionally been high, has continued to increase, but here the point is not so much extending coverage, but increasing the value of the pension for those that receive such benefits.
4. A set of rules in the tax code which allows employees to set up a defined contribution plan for individual employees who then decide on the options that they select for investment in market equities. See Chapter 7 in this volume.