1 The European dimension of the pension challenge

Workplace pension schemes represent social, labor market, and economic goals. They provide social protection in old age and serve as staff retention device for firms' most valuable employees. They have also been used as a financial service instrument to complete the single market in the European Union (EU). While much has been written about the social function of workplace pensions, less attention has been devoted to the use of pensions as market-making device in the EU. Yet, studying the role of workplace pensions in the EU's internal market is intriguing because it highlights tensions between supranational regulations and domestic pension systems.

In the European Union, age-related spending represents a large share of public expenditure and is therefore an issue of common concern among the member states. Pensions from public pay-as-you-go (PAYG) schemes are the main source of income for older Europeans. In 2012, the EU as a whole spent more than 10 percent of gross domestic product (GDP) on PAYG pensions. This share is expected to rise to 12.5 percent of GDP in 2060 (European Commission, 2012b: 4). Due to declining fertility rates and increased life expectancy, the population aged sixty-five and above is expected to increase markedly in the coming decades. This group will almost double, rising from 87.5 million in 2010 to 152.6 million in 2060 in the EU (European Commission, 2012a). Unfavorable demographic developments, falling employment rates, and persistent financial instability put enormous pressure on public budgets and make it harder for state pension systems to deliver on benefit promises.

To confront these challenges, many countries have provided citizens with economic incentives to build up workplace pensions. However, the expansion of occupational pensions remains less effective as long as they are not transferable across borders. Barriers to workplace pension portability, such as differential tax, investment, and social regulations, imply that people who move across borders lose a significant portion of their pension entitlements. Thus, the prospect of pension losses has prevented people from exercising their right to live and work in other member states. Segmented pension markets also impose high administrative costs on multinational firms, who have to comply with twenty-seven different tax, investment, and social regulations. About 83 million people in Europe were covered by a workplace pension plan in 2010[1] and European pension funds managed assets worth 3.5 trillion euros, or 30 percent of the European Union's GDP (European Commission, 2010). The absence of a level playing field in the area of cross-border pension portability has long inhibited pension funds from using the internal market efficiently. Lower returns on investments entail higher costs for the pension industry, ultimately leading to lower incomes for Europe's savers.

Growing concerns over the incompatibility of funded pension schemes with cross-border labor mobility catapulted this issue onto the European Commission's agenda.[2] After decades of acrimonious negotiations and bargaining failure[3] in the 1990s, the EU member states adopted a directive on "the Activities and Supervision of Institutions for Occupational Retirement Provision" (IORPs), wherein member states agreed on the minimum harmonization of investment rules, anti-discrimination measures, and a common supervisory framework.[4]

This path-breaking agreement constitutes the first step towards a single pension market. It permits the establishment of pan-European pension funds that manage the pension schemes of employees in different member states. This arrangement facilitates the cross-border portability of individuals' workplace pensions and enables multinational firms to save costs by allowing them to manage all of their employees'

[1] This estimate includes both defined-benefit and defined-contribution schemes.
[2] In fact, the EU's legislative activity in the area of pensions is nothing new. For the past five decades the EU has issued regulations on the coordination of social security systems to protect the *social security* pension rights of mobile EU citizens. The novel issue discussed in this book is the EU's activism in the area of *workplace* pensions.
[3] The proposal that resulted in negotiation breakdown was the Proposal for a Council Directive relating to the freedom of management and investment of funds held by institutions for retirement provision, COM (1991) 301 final, OJ C 312, 3 December 1991.
[4] Directive 2003/41/EC of 3 June 2003 on the activities, and supervision of institutions for occupational retirement provision (IORPs).

pension assets in a single country, rather than twenty-seven different states.[5]

Pension market integration has profound political implications. European legal constraints have greatly reduced the capacity of national governments to influence workplace pension policy, notably in the areas of investment rules, waiting and vesting periods,[6] treatment of foreign pension funds, and regulatory supervision. Because a single pension market creates direct links between domestic pension regulations and global finance, pension funds become uncoupled from the national political economies they have traditionally served (Ferrera, 2005). Since this uncoupling disturbs traditional practices and interest constellations, the growing number of EU pension directives produces intense political conflicts. Market integration and the management of cross-border externalities may drive EU legislative activity in this area, but the shaping of national pension policy choices is the outcome.

1.1 Summary of the main argument

Despite progress in pension market integration, there is a general unwillingness to acknowledge the European dimension of the pension challenge. If scholars were asked who has control over pension policy in the European Union, most would give the same answer: only the member states! Control over pension regulations is considered one of the hallmarks of the sovereign nation-state. National governments are known fiercely to guard their social policy autonomy against intrusion by Brussels.

The European dimension of the pension challenge has been ignored in the literature because the EU is routinely portrayed as a regulatory polity that specializes in apolitical issues of market creation (notable exceptions are Natali, 2008 and Guardiancich and Natali, 2012). According to standard accounts of the European Union, only the

5 There are currently eighty-four IORPs in Europe that are operating cross border. Nine countries are home states to IORPs while twenty-three states act as host states (European Insurance and Occupational Pensions Authority, 2011).

6 The waiting period is the elapsed time before an employee earns the right to a corporate pension claim. The vesting period denotes the time from acquiring corporate pension contributions until the benefits are actually owned by the employee.

member states are in control of highly politicized government functions, such as pensions and other social policies. Voters pay little attention to the EU because legislative activity only concerns issues of low political salience. While the EU's task is to oversee market-creating regulations, it is considered patently unfit to handle politically charged conflicts of social policy that can only be settled by democratically elected governments.

This book disagrees with this notion. We show that the EU influences national pension policy choices, and that national pension regimes have shaped the European single pension market. Pension policy developments at the national and EU levels are linked in two ways: debt and deficit constraining treaties, such as the Maastricht Treaty, exert pressure "from above," compelling European governments to overhaul their costly public pension systems. In turn, the gradual harmonization of workplace pension regulations arises "from below," reflecting hard-won compromises between member states with radically different pension systems. In this book, we develop a theoretical framework that accounts for the transformation of pension policies in the member states, and the creation of a single pension market at the EU level. The theory will be introduced in four steps.

First, we investigate the sources of pension reforms many European states have implemented in the 1990s and 2000s.[7] Given the high risks associated with the overhaul of public pension systems, it is puzzling to observe that so many countries have either introduced funded components to their PAYG pension systems or created incentives for building up workplace pensions. Such reforms are considered high-risk political endeavors because they replace the principle of public social insurance with more individual responsibility for old age income. Organized beneficiaries of public pension benefits are expected to oppose such measures. Existing studies are limited in explaining the reforms. Works attributing pension reform to purely domestic pressures, such as rising longevity and low fertility (Taverne, 2001; Disney, 2003) cannot account for the timing of pension reforms. Studies that have linked pension regime transitions to the diffusion of policy ideas (Orenstein, 2003, 2008; Weyland, 2005; Brooks, 2007; Gilardi, 2010) have convincingly demonstrated that diffusion dynamics have shaped pension

[7] Most West European countries opted for the introduction of funded components, rather than wholesale privatization.

privatization measures in Latin America and Eastern Europe. Yet, no study has found a relationship between learning processes and pension reforms in *Western* Europe (the countries we are interested in). If domestic factors fail to explain the timing of the observed reforms, and diffusion dynamics do not apply in the case of Western Europe, we must consider other sources of policy change. We propose that the observed pension reforms in Western Europe are causally related to the fiscal constraints of the Maastricht Treaty. Using an event-history set-up, we hypothesize that the Maastricht criteria, which limit the build-up of public sector deficits and debt over time, acted as "common shock" for the implementation of pension reforms in several member states.

While EU treaties exert a constraining effect on national pension regimes "from above," the gradual harmonization of workplace pension regulations arises "from below." The adoption of the IORP directive, which established the harmonization of investment rules, the non-discrimination of foreign pension institutions, and an EU-wide supervisory regime for pan-European pensions, is genuinely puzzling: what explains member state cooperation in such an "un-European" policy area? Given that workplace pension regulations differ radically across countries in terms of their function, financial design, and levels of social protection, one might have expected workplace pensions to remain trapped in national systems. Adjusting to a single pension market will be relatively painless for countries with a Beveridgean pension system,[8] but costly for countries with a Bismarckian insurance culture.[9] Thus, our second task is to analyze how the "battle" of pension regimes played out at the EU level.

Our theoretical contribution is to show that governments' capacity to send costly, and therefore credible, signals to one another is the key to successful EU institution-building in this policy area. Although many member states may prefer pension market integration to fragmented pension markets, they will not agree to policy change at any price. Member states with low costs of reform may be willing to accommodate governments whose reform costs are high, but it is difficult for them to distinguish between member states with genuinely high

[8] Beveridgean countries include the UK, Ireland, the Netherlands, Denmark, Sweden, and Switzerland. For a comprehensive analysis, see Ebbinghaus, 2011.
[9] Bismarckian countries include Germany, France, Belgium, Austria, Greece, Spain, and Italy. *Ibid.*

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costs of reform and governments who are "bluffing" in order to get a more favorable EU agreement. In this situation, the domestic pension reform discourse will serve as a signal about the country's type: a reform-oriented pension policy discourse serves as a costly and credible signal that a country has genuinely high costs of adapting to a single pension market, whereas a status quo oriented pension policy discourse indicates "cheap talk" and is therefore not credible.

Two-level game approaches have convincingly demonstrated that domestic veto points can increase a government's bargaining power in multi-level negotiations (Schelling, 1960; Putnam, 1988). However, this scholarship has failed to explain why international negotiations may break down despite governments asserting that their domestic win-set is constrained. In the same vein, liberal intergovernmentalists (Moravcsik, 1998) cannot explain why negotiations over a pension fund directive broke down in the early 1990s. At the time, the member states had a strong incentive to cooperate on a single pension market since unfavorable demographic developments, soaring unemployment rates, and financial exigencies had exerted pressure on PAYG pension systems. Although member state preferences had converged, negotiations ended in deadlock in 1994. According to liberal intergovernmentalism, however, bargaining should never break down when there is preference convergence. Our analysis shows that a government's inability to demonstrate *credibly* that domestic constraints are a major obstacle to EU harmonization efforts can lead to negotiation breakdown. This argument comports with a growing stream of research that has shown that informal governance tends to be more consequential for the design of international institutions than formal decision-making procedures (Koremenos, 2001; Christiansen and Piattoni, 2003; Farrell and Héritier, 2003; Achen, 2006; Stacey, 2010; Stone, 2011).

Third, informal signaling and communication flows also influence the effectiveness of the European Commission as agenda setter. As the only institution in the EU that can formally propose legislation, the Commission can play a powerful role in securing member states' commitment to EU covenants. However, failure to act as "efficient" agenda setter may cause the Commission to get defeated in the formal decision-making process. As a result, the Commission has an incentive to assemble strategic coalitions before a proposal is put to a formal vote. Using primary document analysis as well as interviews with EU Commission officials and pension industry representatives in

Germany and Britain, we find that pension market integration becomes more likely if the Commission can trim a crowded agenda, set aside internal rivalries, and enhance the quality of information flows regarding workplace pension reform options and limits in other countries. In turn, a lopsided representation of supply-side interests, rivalries between Directorates-General (DGs), and failure to restrict the menu of policy options will diminish the Commission's chances of garnering support for EU pension directives.

Fourth, we gauge the real-world relevance of the theoretical considerations with an in-depth analysis of the pension policy discourse in Germany and Britain. The pension systems in both countries reflect the ideal types of Bismarckian insurance cultures and Beveridgean pension fund systems, respectively. Due to ideological disagreements over the proper role of occupational welfare, political incumbents representing Bismarckian and Beveridgean pension regimes are expected to advocate radically different visions of a European single pension market. The two case studies carefully trace the pension policy discourse in Germany and Britain between the early 1980s and 2007, highlighting how domestic pension policy ideas informed actors' bargaining stance at the EU level. Space constraints prevent the inclusion of more than two case studies in the book. However, we exploit the fact that other EU countries with Bismarckian pension systems sided with the German position, while member states with Beveridgean pension fund cultures supported the British viewpoint. Thus, Germany and Britain represent critical cases.

Germany's position on the single pension market was heavily influenced by its concern over unfunded book reserve pensions, the most popular vehicle of workplace pension provision in the country. Helmut Kohl, Gerhard Schröder, and Angela Merkel all tried to protect employer-sponsored book reserve pensions from the scope of EU directives. By contrast, Britain's stance on the single pension market was shaped by Tony Blair's commitment to continue Margaret Thatcher's philosophy of individual risk-taking. As a result, the British pension policy discourse is characterized by bitter disputes between the financial services industry demanding lax EU pension regulations and consumer advocates requesting more efficient protections against missellings and corporate pension losses.

This book employs statistical analysis, formal modeling, and case study research. In combination, these modes of analysis offset one

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another's shortcomings. Quantitative analysis may identify empirical patterns and correlations, but fails to establish nature and direction of causal effects. A formal model allows us to derive hypotheses and illustrates possible results of strategic interaction, but without an in-depth analysis of pension policy developments in individual countries we cannot establish validity of the assumptions or gauge the real-world relevance of the findings. Without any of these methodological supports, scholarship becomes unreliable, like a "stool with only two legs" (Stone, 2002: 235). When combined, however, the result is a more thorough picture of economic interests, informal signaling, and EU institution-building in the area of workplace pensions.

Our findings contradict the standard account of the EU as a regulatory polity that specializes in apolitical issues of market creation and leaves control of highly politicized government functions to the member states. The gradual emergence of the single pension market suggests that the EU is more active in the area of social policy than standard accounts have allowed for. Market integration and the management of cross-border pension portability may be the drivers of EU pension regulations, but the result is a constraining effect on domestic pension policy choices.

2 National pension regimes, supranational harmonization efforts

In this chapter, we provide essential background information that is necessary to understand what is at stake in the process of pension market integration. National pension systems are under pressure due to unfavorable demographic developments, financial constraints, and new social risks that are not covered by many traditional pension plans. These pressures politicize workplace pensions in new ways and differently across divergent types of pension regimes. This creates dilemmas for would-be reformers in Europe. On the one hand, the EU-wide harmonization of workplace pension regulations is attractive for large corporations in Europe because compliance with a single regulatory framework is easier and more cost-effective than compliance with twenty-seven different regulatory systems. Individuals also stand to gain from pension market integration since they would no longer lose pension benefits and rights if they moved across borders. On the other hand, even a partial harmonization of pension regulations at the EU level produces winners and losers since certain pension regimes are inherently better suited to accommodate EU-mandated change than others. Thus, the creation of a single pension market represents a classic cooperation problem: converging on common rules is desirable in principle, but deep divisions exist over objective and means of harmonization. Countries facing high costs of adjusting to EU directives will seek to keep the pain of reform to a minimum. This makes any common policy hard to adopt.

To understand the factors that affect the choice set of would-be reformers, we first lay out how unfavorable demographic developments and new social risks put pressure on first-pillar pension systems. We then identify the multiple functions of workplace pensions in different countries to illustrate why the creation of a single pension market is a particularly difficult endeavor for EU harmonization efforts. The chapter concludes with a discussion of the goals and challenges of pension market integration.

2.1 Pressures on public pension systems

The pension systems of all EU member states consist of two tiers. The first entails the social security programs established by statutory legislation. The second is made up of employment-based arrangements created by employers, employer associations, and labor unions. In the second tier, these actors – and not the government – are responsible for administering the plans.[1] Many pension systems also consist of a third tier, which refers to private pensions. In this case, it is the individual beneficiary – and not the state or the employer – who accumulates savings for his retirement. Different designs of pension schemes have crucial consequences for financial markets, labor relations, and the interaction of these two institutions for the welfare state.

Population aging

It is now widely understood how contingent the PAYG pension schemes, financed by payroll taxes or social security contributions, are on favorable demographic developments. After World War II, most advanced industrial nations introduced major measures to extend social citizenship rights to pensioners, whether in the form of the New Deal, the Beveridge Plan, the Nordic Peoples' Home, or the *grosse Rentenreform* (Esping-Andersen, 1996). German chancellor Adenauer's well–known observation that "people will always have children" reflects the widespread belief that the ratio of those paying contributions and those receiving pension benefits would always be auspicious. Indeed, few political leaders had reasons to doubt the long-term sustainability of the so-called generational contract because, in the 1950s and 1960s, approximately eight workers financed the retirement income of one pensioner.

Public finances are hugely influenced by pension expenditures. Today these expenditures represent approximately 10 percent of GDP in the twenty-seven member states, and are expected to increase further due to aging and low fertility rates to 12.3 percent in 2060 (European Commission, 2010). In addition to the increase in pension expenditures, member states will also have to finance age-related spending on

[1] The terms corporate pension, second-pillar, workplace pension, employer-sponsored pension, and occupational pension all refer to work-related retirement income and are used here interchangeably.