

**The future of the welfare state: paths of social policy  
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**Structures, political competition and societal veto players: the politics  
of pension reform in Southern Europe**

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Stream: Reforms of welfare systems in Southern European countries

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**Abstract:** Over the past twenty years, dramatic demographic changes and negative economic trends have put significant pressure on the financial sustainability of southern European public pension systems. While governments in the region have responded through a series of reforms that reduced the generosity of pension provision, promoted supplementary pension provisions and introduced minimum income schemes that were absent in these countries (Greece still being an exception) thereby following closely on the path observed in other European countries, a closer look shows different degree of reform success across the cases of Spain, Italy, Portugal and Greece. Thus, while Italy has been able to adopt more path-breaking reforms that ultimately reduced the generosity of the public pension system significantly while enhancing the role of the second pillar, reform in Spain has been more modest although the measures adopted have helped strengthen the financial sustainability of the first public pillar. Meanwhile, pension reform efforts have largely stalled in Portugal and Greece, and recent reforms have only been approved after providing significant concessions to the labor movement. What factors account for this variation in reform outcomes across these four cases? We argue that structures, the nature of political competition and organized labor's preferences have shaped the outcome of pension reform. The extreme yet unequal generosity of the public pension system coupled with negative demographic trends led to significant deficits in the early 1990s in turn prompting governments to propose significant and urgent reforms in Italy and Greece while such factors played a less critical role in Spain and Portugal. However, the role of political competition and labor unions explains much of the success of different reform initiatives. In Italy, minority executives that were more independent from voter preferences successfully pushed for significant reforms while Spanish governments more threatened by the logics of political competition, have led more moderate reforms since 1995. In both cases, labor has supported reform after obtaining some key concessions. In contrast, governments in Portugal and Greece have usually been much more dependent on the political impact of pension reforms and they have faced stronger opposition by the labor movement. In this setting, the outcome has usually been very moderate reforms in scope whose effect has been diluted due to the concessions provided to organized labor.

## **I. Introduction**

Since the post-war period, most Continental European countries have structured their public pension systems following the traditional Bismarckian model, where benefits aim at replacing a high proportion of income before retirement, while the system is funded according to the pay-as-you-go (PAYG) principle under which current employees pay for the benefits of current retirees. This system of a well extended earnings-related public pillar worked well in a period of sustained economic growth, low ratios of retirees to active workers and relatively low unemployment levels. However, since the late 1980s, longer life expectancies, declining birth ratios, early retirement waves, declining growth rates and increasing funding deficit levels have been highlighted as a cause of concern for the sustainability of PAYG public pension systems by many analysts. The main problem pointed out by experts is that paying for generous pension benefits in a context of an ageing population will lead to unbearable public pension expenditures in the near future which will impact negatively on countries' fiscal balances. Thus, the reform of PAYG public pension systems has become a central public policy issue for many European countries since the early 1990s.

Southern European countries are particularly pressed to reform their public pension systems due to some common negative tendencies that have been pointed out in the specialized literature (Ferrera 1996; Petmesidou 1996; Katrougalos and Lazarides 2008). Specifically, high fragmentation and inequity levels among pension schemes, the lack of an efficient administration and clientelism have been highlighted as aspects contributing to the financial imbalances of these systems. More recently, increasing old-age dependency ratios, persistent deficit levels, coupled with governments' need to put public finances in order to comply with the last stages of the Economic and Monetary Union (EMU) in the 1990s, led them to push for significant reform. However, a closer examination of reform paths shows varying degrees of success across the cases of Spain, Italy, Portugal and Greece. In particular, while Italy has been able to adopt more path-breaking reforms that ultimately reduced the generosity of the public pension system significantly and enhanced the role of the second

pillar, reform in Spain has been more modest although the measures adopted have helped strengthen the financial sustainability of the first public pillar. Meanwhile, pension reform efforts have largely stalled in Portugal and Greece. What explains this different degree of reform success in these countries?

There is by now an extensive literature on the evolution and the politics of welfare and pension systems in the southern European continent (Ferrera 1996; Leibfried 1992; Petmesidou 1996; Katrougalos and Lazarides 2003, 2008). However, this literature has been rather silent about the specific mechanisms of pension reform in this region. Thus, the goal of this comparative study is to elaborate and apply a theoretical framework to understand the politics of pension reforms in these countries.

By combining the insights of different approaches on the politics of pension reform, and by re-elaborating key aspects of some of them, we aim to provide a comprehensive approach to understand how pension reform takes place in Southern European countries. In so doing, we claim that there is not a causal mechanism that is exclusive of the Southern European spectrum; rather, we aim to show that conventional approaches must be re-adapted in a specific way to understand how reform takes place in these countries.

We argue that structures, the nature of political competition and organized labor's preferences have shaped the outcome of pension reform. Thus, the politics of pension reform in this region seems to proceed in the following way. First, structural socio-economic factors such as pension deficit funding levels, which are a cause of the extreme generosity in the provisions of the system, and worsening demographic factors help to put the need for reform in the public agenda. In addition, supranational institutions such as the EU and, in the 1990s, the need to comply with the EMU convergence criteria, also put some pressure on domestic policy makers for seeking solutions that will improve the long term sustainability of the system.

Second, policy makers will have to elaborate a reform proposal to address the different pressures for reform. At this stage, the logics of political competition will be central

in explaining the degree of reform included in the reform proposal. If policy makers feel protected against the reaction of potential “losers” (i.e. if pensioners and workers are not well organized) and therefore the “political replacement effect” is fairly low, they will seek a far reaching reform. By contrast, if they feel their replacement may be certain in the next elections or that coalition members may not support their initiative and lead to a crisis of government, they will either propose limited reform or even withdraw the reform proposal.

Finally, the role of the labor movement and its preferences over the pension system will be significant in explaining whether they will oppose reform proposals or they will accept some reforms in exchange for some compensations. Thus, in countries in which the labor movement has abandoned highly particularistic and ideological positions on pension policy (Spain and, to some extent, Italy) significant reforms will be possible but some specific concessions will be needed to “compensate” potential losers. By contrast, if the labor movement adopts a more radical approach to pension policy, reforms will usually stall (Greece and Portugal).

After this short introduction, the next section will focus on elaborating a common theoretical framework. The following four sections will illustrate how our theoretical framework applies to the cases of Spain, Portugal, Italy and Greece. Finally, the last section discusses the commonalities and implications of our analysis.

## **II. Towards a common explanation of reform in Southern Europe**

The pioneering work of Esping-Andersen (1990) made no reference to the welfare regimes of Southern Europe, with the exception of Italy classified under the conservative-corporatist model. In the years that followed the cases of Portugal, Spain, Italy and Greece have increasingly attracted the attention of scholars (Leibfried 1992, Petmesidou 1996, Ferrera 1996, Katrougalos 1996, Bonoli 1997, Katrougalos and Lazarides 2003 and 2008) giving rise to a debate concerning their categorization either as a sub-category of the corporatist model or as a distinct variant. Thus, for some scholars, Southern welfare states share common characteristics such as their delayed expansion attributed to their socio-

economic underdevelopment and late democratization, the predominance of old-age pensions in cash transfers, high inequalities, the persistence of poverty and the absence until recently of social minima (Katrougalos 1996 Katrougalos and Lazarides 2003, 2008). For other scholars, Southern countries shared until the end of the 90s a series of common and specific characteristics that distinguished them from other European cases: a highly fragmented and corporatist income maintenance system, a low degree of state presence in welfare provision, a strong influence of the catholic church (with the exception of Greece), the persistence of clientelism and selectivity in the distribution of cash subsidies, the coexistence of a corporatist tradition with universalistic national health services, the lack of efficient administration and lastly an over-representation of political parties in the mediation of social interests hindering the formation of consensus (Ferrera 1996).

We contend that while this literature provides an overall satisfactory picture of the structure of welfare and pension systems in the Southern European continent, it is rather silent about the specific reform mechanisms found in these countries. Thus, in elaborating a common framework to understand recent reforms, we wonder whether there is a reform mechanism specific to the Southern European region or if reforms in this region can be understood by combining the insights of theories on pension politics that have been applied elsewhere.

In general, two sets arguments have been elaborated to understand the reform of pension systems in the political science and political economy literature. One first set of arguments have looked at the role played by international and supranational institutions and their degree of influence over domestic policy makers to adopt reforms that are in light with their recommendations for more sustainable pension systems. Particularly in Europe, this literature has analyzed the role that EU institutions play on influencing domestic pension policy reform and by now there is a well developed literature on the “Europeanization” of pension policy reform (Radaelli 2002; Schmidt 2002; Schmidt and Radaelli 2004). This literature has convincingly demonstrated that during welfare reforms in countries with a significant degree of “misfit” between the ideals promoted by EU institutions and their

current situation, policy makers may often incorporate in their discourse some of the main aspects highlighted by EU institutions (such as the necessity for “sound policies” and a “fair treatment” of the different cohorts) to strengthen the case for reform. In this sense, this literature makes the case for a “cognitive” or “indirect” effect of EU institutions on the reform process. More recently, scholars analyzing the “indirect” effect of the EU on domestic pension policy reform have looked at the role played by the Open Method of Coordination (OMC). This new governance method, applied to the field of pension policy since the 2001 Lisbon European Council, consists in the agreement among member states on certain common objectives and parameters to implement reforms upon recommendations laid down by the Commission. Thus, the main insight of this literature is that while the EU can certainly help to build some consensus for reform and have some “indirect” effect on pension policy, the locus of the reform process lies still at the domestic level.

In this sense, a second set of explanations has looked at the role played by domestic socio-economics structures, political institutions and actors with a capacity to block reforms (veto-actors). In terms of socio-economic structures, some scholars point out that significant government budget imbalances (to which the deficit of the public pension system contributes significantly) and increasing old-age dependency ratios make public pension systems unsustainable triggering the need for reform. For example, Bonoli and Shinkawa (2005) argue that the degree of crisis represented by key socio-economic indicators together with specific political-institutional configurations determined the degree of reform in a number of West European, North American and Asian countries. Scholars studying the politics of pension reform in Southern Europe and elsewhere tend to coincide with the perspective elaborated by Bonoli and Shinkawa (2005) but stress the fact that while structural socio-economic pressures may trigger the need for reform, they do not determine the specific outcome (Rhodes and Natali 2004; Rodriguez Cabrero 2002; Brooks 2008; Madrid 2003). Thus, it seems that the specific reform outcome will be determined by specific political factors.

There is by now a quite well developed literature that looks at the role of political institutions in explaining the degree of pension reform. In general, such analyses make a clear

distinction between political actors and the institutional frameworks within which action takes place. Political actors formulate their goals, ideas, and desires independently from institutions. However, by making some courses of action more difficult and by facilitating others or, in other words, by facilitating or restricting windows of opportunities (veto points) to political actors that oppose reforms, institutions set the strategic context for actors to better achieve their goals. For example, in a comparative study on health insurance in Sweden, France, and Switzerland, Immergut (1992) emphasized the importance of the centralization and insulation of the executive power from parliamentary and electoral pressures as a precondition for significant changes of the status quo.

The work of Tsebelis (2002) and his “veto player” theory has led to a number of analyses on pension reform that have aimed to apply this theoretical insight (Bonoli 2001; Featherstone 2004; Natali 2004). In Tsebelis’ approach, veto players are individual or collective actors whose agreement is necessary for a change of the status quo. In addition, he argues that veto players can be generated by the constitution (president; congress; the courts) or by the political game (political parties; party coalitions; the military; labor unions). The main implication of his theory is that as the number of veto players increases, policy stability (or the impossibility to change the status quo) increases. The veto player framework has been applied to a number of analyses on welfare and pension reform with a significant degree of success. For example Bonoli (2001) explains that political institutions that provide power concentration for the executive and fewer veto points for opponents facilitate reforms. This is why such reforms have been far more successful in Britain than in Switzerland. However, Bonoli’s analysis differs from typical “veto player” explanations on economic reforms because he argues that the impact of political institutions is mediated by electoral results and by the mobilization of strong societal groups like labor unions. Therefore, if executives are not backed by a strong support in parliament and if they face strong opposition from the labor movement, they will tend to negotiate reforms. This explains the divergent outcome of pension reforms in 1993 and 1996 in France (Bonoli 2001:259)

A similar re-adaptation of the institutional and veto player approach has been adopted by Anderson and Immergut (2007). Interestingly, they correctly observe that far reaching reforms have been adopted in recent years across many western European countries that are characterized by a significant number of veto players; for example, Italy, Finland and Switzerland. By contrast, reform has stalled in countries with few veto points or veto players, such as Greece, the UK or France. Thus, they argue that the logics of political competition may explain this divergence from the veto point and veto player theory. In a nutshell, they argue that when the logics of political competition is intense because, for example, the electoral system provides ways for voters potentially affected by the reform that is being discussed to vote against the government, then policy makers will seek a consensus for the reform or they will withdraw their reform proposal.

As Anderson and Immergut (2007; p.37) rightly point out, the concept of political competition needs further elaboration in order to understand how it plays a key role in explaining episodes of reform. We propose to follow Anderson and Immergut (2007) recommendation to elaborate more on the concept of political competition as we think it is a key component, although not the only one, that explains the pattern of reform in Southern European countries.

We theorize that central to understanding how political competition determines the outcome of pension reform is the extent at which the stability of the government is threatened as a consequence of coalition partners and voters' preference on the reform that is being debated. Thus, in situations where policy makers feel they will be punished by coalition partners or voters if they pass a given type of reform, they will either seek a consensual proposal or back down from far-reaching reforms for which there is little support. Here, we re-take the political economy concept of "political replacement effect" as key to understanding why policy makers may be more or less prone to implementing reforms that are political costly.

As Acemoglu and Robinson (2002) elaborate, economic reforms are economically beneficial but politically destabilizing, meaning that an incumbent ruler must balance his/her

incentive to reform against his/her incentive to keep his/her position secure (and thus, not being replaced in the next election). In settings marked by low levels of political competition, the latter consideration plays a small role: the incumbent faces little risk of losing power in any case, and is therefore emboldened to undertake reforms that may help to secure his power. However, when political competition is more intense, the destabilizing effects of economic reforms (and thus the probability of being replaced) weigh more heavily on the incumbent, leading in many cases to a no-reform. We posit that such an approach is particularly useful to understand the pattern of pension reform in Southern European countries, where pension policy has become a highly contested topic due to population ageing and the traditionally generous provisions of these systems. Thus, policy makers will usually look at the possible reaction of potential “losers” (retirees and workers) and their supporters in Parliament, when having to decide upon the content of reforms.

In understanding how the logics of political competition and its political replacement effect works, it is useful to re-adapt some key insights from the “new politics of welfare retrenchment”, as elaborated by Pierson (1994) and Pierson and Weaver (1993). Pierson’s key observation is that the politics of welfare retrenchment is different to that of welfare expansion. The politics of welfare retrenchment places voters and electoral politics in a central position. Because of how voters view economic reforms that may affect their future wellbeing and because they may punish policy makers in the next elections, when retrenchment is needed policy makers will embark into blame avoidance strategies, trying to “hide” the effect of retrenchment reforms. Typical measures entail the introduction of obscure forms of cuts in benefit formulas or long transition periods for the effective introduction of reforms. Other typical measures to “hide” the effect of retrenchment reforms include the exemption of certain cohorts from the retrenchment measures (retirees, older workers) who are typically more politically active and thus more likely to punish the government through their vote, in detriment of younger cohorts who are less likely to be unionized or to actively punish the government with their vote.

One additional factor that must be taken into consideration is the role of the labor movement, which, especially since the late 1960s (in Italy) and since the democratization in mid 1970s (in the case of Portugal, Spain and Greece) has become a key veto actor with whom reforms must be negotiated. In these countries, as in the rest of the continental European countries that follow a corporatist tradition, pensions are seen as “deferred wages” and therefore labor unions will try to bargain hard in order to avoid cuts that will put future and current retirees in a worse off situation. In this sense Pierson (1994) has argued that policymakers may still get labor unions’ support by trying to divide them and weaken them or by compensating them for the potential losses. The latter type of strategy may imply the introduction of clauses that protect these groups’ interests such as: lowering the retirement age from what policymakers had originally proposed or excluding some cohorts from being affected by the proposed reforms. Such approach has been examined by scholars interested in pension reform in Southern Europe who talk about the re-emergence of new “corporatist” pacts between government, labor and business associations (Rhodes 2001; Rhodes and Natali 2004). These scholars agree on the fact that the specific preferences of labor unions (i.e.: protecting older workers and retirees vis a vis young workers) will be key to determine the specific concessions that will be necessary to give in exchange for the support for reform. We claim that while this perspective is correct, it must be taken into account together with the role of structural socio-economic pressures and the role of political competition.

In sum, we argue that the politics of pension reform in Southern Europe entails three different aspects. First, structural socio-economic factors such as pension deficit funding levels, which are a cause of extreme generosity in the provisions of the system, and worsening demographic factors will help to put the need for reform in the public agenda. In addition, supranational institutions such as the EU and, in the 1990s, the need to comply with the EMU convergence criteria, will also put some pressure on domestic policy makers for seeking solutions that will improve the long term sustainability of the system.

Second, policy makers will have to elaborate a reform proposal to address the different pressures for reform. At this stage, the logics of political competition will be key to

explain the degree of reform included in the reform proposal. If policy makers feel they are protected against the reaction of potential “losers” from the reform (i.e. if pensioners and workers are not well organized to bargain legislators to oppose reform) and therefore the “political replacement effect” is fairly low, they will seek a far reaching reform. By contrast, if they feel their replacement may be certain in the next elections or that coalition members may not support the initiative and lead to a crisis of government, they will either propose limited reform or they will withdraw the reform proposal.

Third, the role of the labor movement and its preferences over the pension system will be significant to explain whether they will oppose reform proposals or whether they will accept reform in exchange of some compensations. Moreover, building upon the insights of Rhodes and Natali (2004) we consider labor unions, and their leaders, as self-interested rational actors who will accept retrenchment measures in exchange for measures that improve their particular position. Thus, in the negotiations for reform, labor unions may accept a mix of public and private pension provision in order to improve the sustainability of the public pension system, if they obtain a privileged role in the management of private funds (as it has been in the case of Italy with the occupational funds, in which unions play a significant role in their management together with employers).

Fourth, in negotiating reforms, the role of the official discourse used to justify the reforms will play a significant role. We therefore argue that successful reform processes may also include a certain official rhetoric that justifies the reforms on the need to reduce “unfair” situations, to some extent, to comply with EU visions of what constitutes sound economic policy. We claim that this may constitute a significant explanatory component of the reform process in Southern European countries which, on the one hand, are strong supporters of the European integration process but, on the other hand, have public pension systems that experience a significant degree of “misfit” with what EU institutions consider as ideal.

### **III. The politics of pension reform in Southern Europe**

#### ***a. The politics of pension reform in Spain***

The main characteristic of the Spanish public pension system is its late organization when compared to other Western European countries<sup>1</sup>. Even though the origins of the system can be traced back to the early 1900s with the introduction of special regimes for public servants and some voluntary insurance schemes for some other occupational categories, the basic structure of the Spanish pension system as it is now known was laid out in the 1960s and 1970s with two important reform laws.<sup>2</sup> This legislation created a system comprising a general scheme (*Regimen General*), which covered around 70% of workers and a number of special schemes (*Regimenes Especiales*) for public employees and other occupational categories.<sup>3</sup> By the end of Francisco Franco's dictatorship Spain still lagged behind other Western European countries in terms of pension and overall social protection spending and coverage. In fact, statistics show that while the EC social protection expenditure average was at 23% of GDP in 1975, that figure for Spain was only 12.1% (FOESSA1983:813). Coverage of the pension system was also seen as weak and even by 1978 35% of the population did not have access to any type of pension benefit (Panizo Robles 1993:255).

The democratization process that started in 1975 put a special emphasis on expanding social protection to "catch up" with European levels (Guillén and Alvarez 2004). The 1978 Constitution incorporated this general concern for more social protection and granted universal extension of social protection coverage to all citizens (articles 41, 43 and 49). Consequently, from 1978 until the election of the first socialist government in

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<sup>1</sup> As explained below, this does not mean that pension arrangements were not in place since an early stage. In fact, different social insurance schemes existed since the early 1900s, run by professional associations (Sociedades de Socorros Mutuos - SSM) and protecting workers against the risks of death and old-age poverty (FOESSA 1983:799; MTASS 2005:5)

<sup>2</sup> These were the 1963 Basic Law of Social Security (*Ley de Bases de la Seguridad Social*) and the 1972 Funding and Improvement Law (*Ley de Financiamiento y Perfeccionamiento*).

<sup>3</sup> Among others, the law established special regimes for: rail workers, miners, agricultural workers, maritime workers, self-employed, civil servants, employees of Franco's National Movement, provincial employees, cooperative workers, domestic service, students, retail workers, civil employees of the armed forces (MTAS 2005, 15).

1982, a series of measures were implemented that led to a significant expansion of pension coverage between 1978 and 1983 (Cruz Roche et al 1985:200; Guillén 1999:10).

As a consequence of the expansive measures of the late 1970s and early 1980s the coverage of the system increased significantly, as well as total expenditure levels, which jumped from 5% of GDP in 1980 to 8.3% in 1982. However, by 1982 still 14.4% of workers were excluded from receiving any social security benefit (FOESA 1983:811).

In 1982, the newly elected Socialist government, which increasingly embraced a neoliberal approach of economic adjustment and restrictive monetary policy to achieve macro-economic stabilization, applied a series of measures to try to rein in pension spending. The most important of these measures was the 1985 pension reform law, which was passed after failed negotiations with the labor confederations. The main goal of the law was to reduce fraud levels, especially on disability pensions and to eliminate pensions given under unclear arrangements (Guillén 1999, 9; MTAS 2001, 26). The law introduced important changes in the parameters of the system: fifteen years of contributions required to obtain a pension (previously ten); benefits calculated using the last 8 years of salaries instead of the last two; stricter controls to get disability and survivorship pensions; benefits adjusted according to the estimated (and not the past) CPI increase. In 1987, the government passed another crucial law, taking advantage of its comfortable parliamentary majority and the weakness of the labor movement, which allowed workers to subscribe private pension plans (Chuliá 2007, 530). In proceeding in this way, the socialist government followed the predictions of our theory as the logics of political competition was totally favorable to the PSOE party. In fact, in the June 1986 elections, the PSOE would obtain 44% of the popular vote, while conserving its own majority in the main legislative Chamber (the Chamber of Deputies – *Camara de Diputados*).

The 1985 law certainly helped to contain expenditure in the public pension system, which would stay at around 8.4% until the late 1980s. By that time, a better

economic outlook and the government's necessity to accede to the demands of the labor movement, which organized a successful general strike on 14<sup>th</sup> December 1988 against a proposed labor flexibility initiative, led the socialist government to implement measures to increase social spending and expand the coverage of the pension system. After negotiations with the labor movement, it was decided to index pensions to past CPI increase and non-contributory pensions were introduced in 1990. These would be the last of a series of measures targeted at expanding the generosity and coverage of the pension system.

A combination of structural, supranational and political events since the 1990s, as advanced in our theoretical framework, put mounting pressure on the sustainability of the pension system and determined the need for significant reforms. On the economic front, the recession of the early 1990s affected employment levels significantly, with the unemployment rate rising above 24% in 1994 and negatively affecting the contribution levels to the public pension system. In addition, the necessity to comply with the Treaty of Maastricht's convergence criteria for the last stage of the Economic and Monetary Union (EMU) put significant pressure on policy makers to commit themselves to contain government spending levels. Even though the financial situation of the Spanish pension system was not as delicate as its Italian counterpart, negative demographic trends with declining fertility rates and increasing old-age dependency ratios made necessary a significant reform of the system.

On the political front, the PSOE was facing increasing competition from the center-right Partido Popular (PP) since the early 1990s and in the general election of June 1993 would lose its majority in the Chamber of Deputies, with the PP just 20 seats short of obtaining a majority. As a consequence, the PSOE was forced to form a minority government with the Catalan and Basque nationalists of *Convergència i Unió* (CiU) and *Partido Nacionalista Vasco* (PNV), respectively. It was precisely during the 1993 election

campaign that the sustainability of the public pension system and its reform would become a central issue. When PP candidate José María Aznar highlighted that “a reform was certainly necessary” Prime Minister Gonzalez used Aznar’s comments to point out that “if the elderly wanted to preserve their pensions they should not vote for Aznar.” (*El Mundo* 6<sup>th</sup> June 1993). The concern expressed by government officials in the following months would lead to *CiU* to propose the establishment of a parliamentary commission that would analyze the system’s sustainability and the need for reform. As experts and protagonists note, the PSOE’s decision to accept an open debate of reform alternatives and not to impose its own like in 1985 was linked to its political weakness and the necessity to seek some consensus on this regard (Panizo Robles 2006; Lagárez Pérez 2001). PSOE’s officials interpreted that the “potential losers” from a far reaching and non-consensual reform (namely retirees and workers) would certainly punish them in upcoming elections (as they had done with the PP in the recent 1993 elections) and therefore accepted to negotiate a future reform.

The parliamentary commission for the study of the reform of the public pension system received the input of specialists from the labor movement, political parties and academics and it concluded its work in March 1995. Shortly after, all parties represented in parliament signed an agreement, the so-called Toledo Pact, which recommended important changes: reducing the specific privileges for some schemes and gradually reducing them to only two; an increase in the proportionality between contributions and pensions; the financing of non-contributive pensions through taxes and not with workers’ contributions (these should be reserved to finance only contributive pensions); the progressive retardation of the retirement age; the use of tax incentives to promote voluntary private pensions; the improvement of widows and survivors’ pensions.<sup>4</sup>

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<sup>4</sup> The recommendations of the Toledo Pact can be consulted at: <http://www.tt.mtas.es/periodico/documentos/Recomen%20Pacto%20Toledo.htm>

The newly elected PP government in May 1996 was in charge of negotiating a reform to follow the recommendations of the Toledo Pact. According to some government officials, even though many within the PP favored a far reaching reform that would diminish significantly the generosity of the system, the government was well aware of its political limitation, and opted for the “best politically feasible” option: “we were well aware of the magnitude of the reforms needed but instead of favoring a major overhaul we just focused on supporting measures to ensure the sustainability of the system.”<sup>5</sup> The reform negotiated with the social partners and later ratified by Parliament included some cost containment measures (gradual increase in the number of years used to calculate the pension benefit from 8 to 15; penalization of early retirement; reduction in the number of occupational schemes; annual adjustment according to wages’ evolution) in exchange for other measures that tended to improve the situation of the less advantaged (an amelioration of the lowest widows’ and orphans’ pensions; no penalization for early retirement if this was due to long unemployment; raise of the age limit to receive orphan survivorship pensions). Throughout the reform process, policy makers and labor movement negotiators would justify the need for the reform on the grounds of reinforcing a “just, balanced, and solidaristic” pension system (MTAS 2006).

The main aspects of the reform process followed the predictions of our theoretical framework. Having learned the lesson from the electoral campaign of 1993, the new PP government, which came to power after winning the 1996 general elections by just over one percentage point over the PSOE and having to make a coalition with the Basque, Canarian and Catalan nationalist parties, was not in a position to push for a far-reaching reform. PP officials were well aware that the “political replacement effect” (the possibility that potential “losers” would punish them in upcoming elections) was fairly high and therefore agreed on a limited and parametric reform of the system. Thus, in the

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<sup>5</sup> Interview with PP main social security advisor, Madrid 2006.

negotiations with social partners they would be able to trade in some cost containment measures (although moderate) with other aiming to improve the situation of some cohorts.

An improving economic outlook since the end of the 1990s, which led to an increase in the number of contributors to the public pension system, has helped to relieve pressure for significant cost containment reforms. However, reforms in 2001 and 2006 have tried to follow the recommendations of the Toledo Pact to ensure the long-term sustainability of the public pension systems. These reforms have followed the logic of the 1996 reform, in incorporating a mix of cost-containment measures with others targeted at improving the situation of specific cohorts. The 2001 reform included an increase in widows and orphans pensions; continuation with the separation of funding sources for contributive and non-contributive programs with a 12 year deadline; flexible retirement after 65 years of age; and the creation of a new centralized entity to administer the whole system (Albarracín 2001).

In 2006, the socialist government signed a new agreement with the social partners that, just like those of 1996 and 2001, contemplated measures to contain costs with some expansion of benefits (El Mundo, May 31st, 2006). Specifically, the 2006 agreement stipulated that there would no longer be exceptions to the minimum number of years required to receive a pension (until then, there were certain provisions that allowed people with more than 12 but fewer than 15 years of contributions to still be considered for a pension). The agreement also included an increase in the pensions of those who retire after 66 years of age (intended to promote late retirement), a delay in early retirement from 60 to 61 years old, and an increase in widows and orphans survivorship pensions for those in the minimum categories.

Since 2008, the impact of the economic crisis on employment levels and contributions to the public pension system, have re-focused the debate on the need for

significant reforms. The PSOE government, which just has a simple majority in the Chamber of Deputies (168 seats versus 153 of the main opposition party, the PP) and its popular support has waned due to the economic recession, is aware of the “political replacement effect” that a significant reform of the system would entail. Therefore, government officials have repeatedly disregarded OECD and opposition parties’ recommendations for significant reforms in upcoming years (*Expansión* 19<sup>th</sup> December 2008).

### ***b. The politics of pension reform in Portugal***

Portugal has an earnings-related public pension scheme with a means tested safety net<sup>6</sup>. The basic structure of the Portuguese pension system consists of two main regimes: the social security general regime (RGSS - including contributory and non-contributory schemes) and the CGA (*Caixa Geral de Aposentações*) for civil servants.

Similar to the Spanish case, the Portuguese public pension system is relatively recent when compared to the Western European experience, at least in terms of the system maturation. However, like in most European countries, the first pension schemes were created at the beginning of the 20<sup>th</sup> century, with the introduction of few voluntary insurance schemes for some occupational categories in the industry sector. The authoritarian Estado Novo regime implemented, in 1935, the first system of mandatory insurance protection, based on the corporatist organization. This was the base of the national social security scheme, as introduced in 1962. This system would be later extended to rural workers in 1969.

The first Social Security Framework Law of the democratic period was passed in 1984<sup>7</sup> (Law 28/84) with the support of two major parties PS (Socialist) and PSD (Social

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<sup>6</sup> To a more developed description about the pension system, see OECD report – Pensions at a Glance 2009: <http://www.oecd.org/dataoecd/18/21/43021621.pdf>

<sup>7</sup> The Decree-Law 160/80 introduced the concept of “Social Security”, with its implications in terms of rights and guarantees. This reform was the result of the democratic transition in 1974. However, the institutional system remained the same (Carolo, 2006).

Democrat, but right oriented). From that date until the 1990s there were some minor important developments that increased the generosity of the system.

The first cost-containment reform took place in 1993 (Decree-Law 329/1993). The PSD government, relying on its absolute majority in parliament, introduced some key cost-containment measures. This law marked a new stage in the evolution of the Portuguese pension system. However, it is worth pointing out that these measures were targeted at introducing some rationality in the system and promoting equity among pension benefits<sup>8</sup>. In proceeding in this way, the PSD government followed the predictions of our theoretical framework as given that the logics of political competition entailed a low “political replacement effect” from potential losers (as the PSD enjoyed an ample majority) the government was able to pass a comprehensive cost-containment reform.

In order to further understand this reform, we should also highlight that a combination of supranational and economic factors also helped to create pressure for reform. On the economic side, the early 1990s economic recession led to a significant shortfall of social security contributions which, in turn, put in evidence the unsustainable character of the public pension system. Increasing old-age dependency ratios and declining fertility rates since the early 1980s also helped to put pressure on the sustainability of the system. In addition the need to fulfil the Maastricht criteria, raised awareness among policy makers on the need to put the system on a sustainable path (Marques, 1997: 32-35).

In the 1995 elections, the PS replaced the PSD in government. The socialists stressed the political goal of improving social protection and the need to pursue a new political strategy focused on social dialogue. Thus, the new PS government agenda in social security included the creation of a minimum income program and a reform of the existing public pension system.

Starting with the 2000 reform, Portugal implemented two other new Social Security Acts in 2002 and 2007. The specialised literature has so far analysed the Portuguese reforms

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<sup>8</sup> For a detailed description of this process see Chuliá and Asensio, 2007: 633-640.

until 2005 (Chuliá and Asensio, 2007). However, the 2007 social Security reform is the most important in terms of the changes to the system.

In 2000, the Solidarity and Social Security Framework Law (Law n.º 17/2000) was approved in the parliament, with the votes of PS (minority government) and the abstention of CDU (coalition with PCP and PEV – Os Verdes) and BE. This reform was a result of a long negotiation process, which started in 1996 with the creation of an experts' commission to elaborate a plan to foster public debate and policy options to reform the social security system. The report produced by the commission (The White Book of Social Security Reform) was delivered in 1998 and was followed by an intense parliamentary activity, where each party presented its own Social Security reform project.

As Chuliá and Asensio point out, the White Paper Report could be seen as a technical instrument to legitimize pension system reform. However, the minority PS government decided to proceed very cautiously, introducing only small changes. Therefore, the changes introduced with the reform were, unsurprisingly, parametric and not structural. The focus was on improving financial sustainability by separating the financing sources for contributory and non-contributory schemes (the former funded out of contributions and the latter funded out to general taxation) and some corrections in the pension formula regarding the number of years considered to calculate pension benefits upon retirement. The introduction of a second private pension pillar and the introduction of new ways to finance social security were discarded.

Some authors interpret that endorsing the Commission recommendations would have been risky given the multiple ideological differences within the PSD and the possible electoral costs (Chuliá and Asensio, 2007: 644). However, this pattern of political competition should be taken with care because the ideology approach is not so obvious if we intend to understand policy options. For example, it should be noted that the different proposals “do not confirm the traditional stances on socioeconomic matters. Parties located on the right of the political spectrum showed extraordinary generosity, and the parties on the left demonstrated attitudes of economic modernity” (Campos, 2000: 176). These aspects could be tied with the different position and expectations in the bargaining process. In the 2000 reform, the

government's strategy of social dialogue with all parties and social partners could also be seen as a need to achieve political support for a minority government and to avoid further electoral costs. Thus, we interpret that given the high "political replacement effect", the government decided to back-down from implementing a far-reaching reform. In this sense, this process was similar to that of Spain since 1993, where weak governments also had to implement limited reform.

In 2002, after the election forced by the resignation of former Prime Minister António Guterres, leader of the minority government of PS, the new coalition government of PSD and CDS/PP (conservative), which had voted against to the 2000 reform, proposed a new Social Security reform. Therefore, the Framework Law on Social Security (Decree-Law 35/2002)<sup>9</sup>, was passed by Parliament in November 2002, with the votes of PSD and CDS/PP.

Despite the different ideological approaches of those who pushed for the 2000 and 2002 reforms, the changes introduced by both reforms were mostly "cosmetic" in terms of institutional structure and pension outcomes effects. In fact, both reforms followed the same goals, namely: i) improving social protection goals and reinforcing equity; ii) enhancing efficacy and efficiency; iii) improve the financial sustainability of the system. The possibility of a contributory upper ceiling (the "plafonamento" issue) was introduced in the 2000 reform, dependent on some conditions. In the 2002 reform, the "plafonamento" was introduced again, without any previous conditions. However, its practical application required the introduction of further legal requirement, which was never put in place. This was due to the fact that in December 2004 the President dissolved Parliament after only 6 months of having empowered a new government to substitute the former Prime Minister José Manuel Barroso, who had resigned in June to become the President of the European Commission.

As a result of this political and economic crisis, the PS led by José Sócrates achieved his first absolute majority in the 2005 elections. Contrary to the previous reforms, the 2007 social security reform was relatively easy to pass, due to the political absolute majority of the

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<sup>9</sup> A description of the main changes of this reform in comparison with the 2000 reform could be found in Chuliá and Asensio, 2007: 637-638, table 13.6.

Government and, probably, because in the context of a political and economic crisis, people were more receptive to the need of implement hard reforms. Throughout the reform process, the Prime Minister would justify the need for the reform on the ground of the “defence of the Social State” and the social security system, emphasizing full public pension provision as the main difference with the privatization proposals of the centred-right parties.

The 2007 Social Security Reform (Law 4/2007)<sup>10</sup> followed the recommendations of the EU and the OECD to ensure the financial sustainability of the system and reduce budget imbalances. However, it should be noted that in terms of government pension spending, the CGA regime for civil servants pensions has been the key component that has contributed to increasing social expenditure since 1980 (OECD, 2008). This system has not been touched by the 2007 reform.

According to recent data on expenditure estimations, this reform had a great impact in terms of financial sustainability, namely by putting pension spending under control and improving the relationship between pension contributions and benefits paid. However, international organisations such as the OECD point out that there are other reform outcomes that should be evaluated, such as pension adequacy and equity.

The improvement in the sustainability of the system determined by the 2007 reform was achieved thanks to two aspects: an increase in the retirement age according to life-expectancy evolution and linking pensions increase to the GDP performance. However, the reform is likely to have negative consequences on poverty risk levels among pensioners and also on the actuarial equity of the system due to the new pension benefit formula. In fact, the new formula will reduce replacement rates for future pensioners by between 24 and 44 % (OECD, 2008).

Even though we can understand how such a far-reaching reform was implemented due to the combination of an economic crisis that emboldened the support for the new government, as advanced by our theoretical framework, it is still surprising to observe the

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<sup>10</sup> The original text could be found at: <http://www.dre.pt/pdf1sdip/2007/01/01100/03450356.PDF>

negative impacts of the reform. Specifically, even though the 2007 reform had a redistributive effect among low-wages workers, the replacement rate will be lower than today's for this cohort. This may be a problem in a country characterized by already high poverty and inequality levels among retirees due to the traditionally different provisions for the Social Security and CGA regimes (Pereirinha, Arcanjo, Nunes, 2009). This may lead to an increase in old-age poverty risk for low salary workers<sup>11</sup>.

In sum, to explain why and how the pension system has changed, it should be noted that the 2000 and 2002 reforms contemplated the upper ceiling possibility (plafonamento), but all the governments, such as PS with minority in 2000, the PSD and CDS/PP coalition with majority in 2002 and the PS with absolute majority in 2007, never implemented it. Probably, the “plafonamento” issue is the most controversial key factor to understand the political process behind pension reform in Portugal. The argument of ideology cleavages to explain the reluctance of the PS government in following the recommendations of the Commission in 2000 has already been mentioned (Chuliá and Asensio, 2007: 644). For the 2002 reform, the same authors refer to the veto power of the president, who was a former member of the PS, as another factor to take in account (Chuliá and Asensio, 2007: 650). Both arguments seem to be right. However, these factors should also be seen as a result of a political culture characterized by strong corporatist tendencies on one side, and strong leftist traditions on the other. The role of the conservative Communist party (Ferrera, 1996) and its Trade Union CGTP, which has always preferred to defend of the public system instead of supporting some limited reforms to correct its distributional inequalities, should also be highlighted. In fact, the discussion of the “plafonamento” was interpreted by the left as a tentative to destroy the public social

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<sup>11</sup> The only policy measure that could be seen as a potential compensation to improve the situation of some cohorts in this retrenchment process was the creation of the means tested solidarity elderly pension supplement (CSI), created in 2005 with the aim of improving the lowest pensions until a defined upper limit (4200 Euros/year in 2006). However, this benefit should be considered in the field of social assistance and not in the pension system.

security system, while center-right parties interpreted it as a measure to reduce the high social security contributions. None of these actors, however, has considered the reform as an attempt to solve the regressive pattern of public pension system. As a final point, contrary to Spain, in Portugal it was never possible to achieve a social pact or consensus to reform social security.

### ***c. The politics of pension reform in Italy***

The main feature in the evolution of the Italian public pension system since the post-war was its use as a clientalistic tool by governments in a context of increasing political participation and economic growth (Regini and Regonini 1981; Ferrera 1997). In effect, since the 1950s the Christian Democratic party (DC) first, and the socialist party (PSI) after, engaged in providing pension provisions to specific cohorts (public employees, agricultural workers, etc) as a way of securing political support. As a consequence, during the 1950s and 1960s, specific schemes were created under the administration of the National Social Security Institute (*Instituto Nazionale di Previdenza Sociale*, INPS) for the self-employed, agricultural workers, craftsmen, housewives and shopkeepers (Regini and Regonini 1981:222). As a general rule, pension benefits across the different schemes would be set at comparatively high levels compared to the contributions they received, an aspect that would lead to important deficit levels over time (Regini and Regonini 1981:221). Another important characteristic of the system was the introduction of seniority pensions (*pensioni d'anzianità*) which allowed workers to retire on a full pension before the legal retirement age as long as they fulfilled a minimum number of contribution years (set at 20 years for public employees). In the late 1960s, labor confederations pressed the government to expand further pension eligibility criteria and to introduce the automatic revaluation of benefits according to past CPI evolution. In practice, this led to maximum replacement rates of between 80% and 100% of last salaries.

The extremely generous provisions of the system coupled with economic and demographic developments in the 1980s and early 1990s made the public pension system financially unsustainable and dictated the need for significant reform. On the demographic side, statistics show that between 1950 and 1980 the fertility rate decreased from 2.5 to 1.7 children per woman while the old-age dependency ratio nearly doubled from 13% to 20%. On the socio-economic side, unemployment rates would consistently increase since the 1970s and stay above 10% since the 1980s. As a consequence, government pension spending nearly doubled in the 1950-1980 period (from 5.5% of GDP to 10%) and the system run consistent deficits since the 1970s. By the 1990s, total pension expenditure would reach 15% of GDP (Ministero del Bilancio 1995).

During the 1980s, several attempts to introduce cost-containment measures were proposed. However, all of these attempts failed due to the logics of political competition, which was marked by very weak governments usually relying on broad coalitions of five parties, with the Christian Democratic party as a pivot point (Ferrera and Jessoula 2007). As advanced in our theoretical framework, in this situation, any cost-containment reform that would reduce the generous provisions of the system would imply a high “political replacement effect” as governments would risk losing their parliamentary support. Even moderate cost-containment reforms that included the unification of the different schemes, a raise of the retirement age and an harmonization or rules for seniority pensions, such as the 1980 Scotti, the 1984 Cristofori, and the 1987 Formica proposals, were blocked in the Chamber of Deputies and/or were followed by a crisis of government that led to new elections.

Political and economic developments in the early 1990s would make reform more likely to occur. On the economic side, 1992 would be a particularly difficult year for the Italian economy as economic growth plummeted while unemployment stayed above 11%, a fact that would affect social security contributions. To make matters worse, in

September the government was forced to take the Lira out of the European Monetary System, which led to a massive devaluation of the currency. Meanwhile, the adoption of the Maastricht Treaty in 1992 included a set of criteria regarding public finances (a budget deficit of less than 3% of GDP and a debt to GDP ratio of less than 60%) that would prove particularly daunting for Italy to achieve as government debt levels were above 100% and government budget deficit, to which the pension system contributed heavily, was at 10.4% of GDP. On the political side, the repercussions of the major corruption scandal known as “Mani Pulite” would bring down the DC-PS government and a caretaker technocratic government was put in place in June 1992 led by former treasury minister Giuliano Amato.<sup>12</sup>

Already in its inauguration speech, Prime Minister Amato stated that “a major reform of Italy’s public finances, while painful, is necessary and it will have the pension system as a central component” (*La Stampa*, July 1st 1992). Earlier that year, labor movement pension expert Guiliano Cazzola warned that a major reform of the system “was necessary and could not wait” and that a future reform should include an increase in the years considered to calculate a pension and an increase of the retirement age (*La Stampa* 31<sup>st</sup> March 1992). Free from the logics of political competition due to its caretaker nature, but conscious of the necessity to achieve the support from the labor movement that would increasingly act as a veto point in pension reform, the Amato government proposed and successfully implemented a reform. The 1992 reform entailed a raise of the minimum contribution years for obtaining a seniority pension in the public sector to 35 years; the raise from 15 to 20 years required to get an old-age pension; and

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<sup>12</sup> As some observers point out, Amato, together with former central bankers like Carlo Azeglio Ciampi and Lamberto Dini, was part of the group of technocrats that since the 1980s were convinced about the necessity of implementing major reforms in Italy’s public finances sector, of which the pension system was an important component (Natali 2004, Radaelli 2002). This group of technocrats would also be firm supporters of stringent EMU convergence criteria as they saw them as an opportunity to commit the country to put its finances in order (Dyson and Featherstone 1999; Sbragia 2001).

the calculation of pension benefits according to average life-time earnings for new entrants to the labor market. As an outcome of the reform, private voluntary pension plans were authorized in 1993 through a special decree law. In passing this reform, however, the government had to give important concessions to the labor movement to secure their support.<sup>13</sup>

In 1994, the newly elected Berlusconi government proposed significant reforms which would spark the opposition of the labor movement and political opponents<sup>14</sup>. The measures would also spark resistance within Berlusconi's heterogeneous government coalition. This coalition was formed by an alliance of Berlusconi's party Forza Italia and the Northern League in the northern regions and Forza Italia and Aleanza Nazionale (the post-fascist party) in the south (Natali 2004:1090). After massive labor demonstrations, the government decided to withdraw the reform proposal and it finally fell in December 1994. A caretaker government was then formed with former finance minister Lamberto Dini as Prime Minister.

Dini's approach to pension reform was be similar to that of Amato and while seeking collaboration from labor and pensioners he stressed the necessity of passing the reform to save the system from bankruptcy and improving the fairness of the system. In the same vein, labor and pensioner leaders also presented the reform as a "mal minore" (minor evil) to improve the financial sustainability of the system and save it from bankruptcy.<sup>15</sup> The reform changed significantly the structure of the system, introducing a new formula for the calculation of benefits based on a worker's full contribution history

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<sup>13</sup> The concessions were related to: 1) a reduction of the number of years to obtain a seniority pension from 40 years, as initially proposed, to 35 years; 2) the calculation of pension benefits according life-time earnings only for new entrants to the labor market; 3) the respect of pension rights for current retirees.

<sup>14</sup> The reforms included the following points: a) increasing the retirement age by one year every 18 months and not every two years as agreed in the Amato reform; b) the indexation of pension benefits according to the expected increase in CPI and not according to the actual CPI evolution; c) a reduction in the calculation of the pension benefits by 1.75 % per year of contribution for every worker with 15 years of seniority or higher; and d) a cut to seniority pensions of 3 % for each year in which the start of the pension was anticipated compared to the minimum retirement age. See Castellino 1995.

<sup>15</sup> Personal interviews with CGIL's main pension experts, Rome-Brussels, 2006.

and not in the last salary levels prior to retirement.<sup>16</sup> The new system implied a significant reduction in the replacement rate of the system. Therefore, the main concessions given to the labor and pensioner movement centered upon the cohorts to be affected by the new system (Rhodes and Natali 2006; Jessoula and Alti 2006). In effect, after the negotiations, it was agreed that the system would entirely apply only to new entrants and that workers with at least 18 years of contributions would retire according to the rules of the old system. Those with less than 18 years of contributions would have their pensions calculated on a pro-rata basis: until 1995 according to the old system and after 1996 according to the new one.

The Dini and Amato reform are good examples of significant reforms undertaken by governments facing low replacement effect. By contrast, the Berlusconi government had to give up to opponents' pressure and subsequently withdraw its original ambitious plans. In addition, the successful Dini and Amato reforms, as well as the more limited 1997 Prodi reform, used a discourse strategy to justify the reforms that focused on the 'risanamento' of public finances, the equal treatment of different cohorts and even on the necessity of passing the reforms to help Italy qualify for the last stage of EMU (Schmidt 2002; Featherstone 2004).

Reforms during the 2000s have followed a pattern similar to that of the 1990s, in which the logics of political competition, as described by the "political replacement effect", have played an important role in determining the degree of reform. In 2001, the Berlusconi government set out plans for an ambitious reform package and asked Parliament to delegate the power to pass a new reform that, among its most important points, included the elimination of the maximum retirement age of 65 years, the introduction of tax incentives for workers who have the right to a seniority pension but

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<sup>16</sup> The system is called "National Defined Contribution" because even though current contributions are still used to pay current retirees, workers' contributions are registered in virtual or "notional" accounts. The registered contributions are indexed every year and the total accumulated is used at the retirement moment to calculate annual pension benefits (adjusted by life expectancy). See Börsch-Supan (2003).

continue in employment, a reduction in employers' pension contributions, and the compulsory transfer of the *Trattamento Fine Rapporto* (TFR)<sup>17</sup> to supplementary funds. In proposing such a far-reaching reform, the Berlusconi government was relying on the comfortable majority obtained by its coalition in the Chamber of Deputies and the Senate. Thus, we interpret this move as following the predictions of our theory in the sense that envisaging a low "political replacement effect", the Berlusconi government pushed for significant reform.

However, opposition from the social partners was strong and a general strike ensued in the spring of 2002 and the debate on pension stalled. The setback in the 2003 elections meant that reforms had to be re-negotiated with Berlusconi's coalition partners and with the labor movement (Natali and Rhodes 2005, 5). The reform was finally passed in July 2004, but included significant concessions for the labor movement and political opponents: the earlier planned reduction in employers' social contributions was eliminated and the use of the TFR for supplementary funds was based on the 'silenzio/assenzo' mechanism.<sup>18</sup> The reform also included a 'jump' (*scalone*) in the minimum retirement age from 2008 to 60 years old and at least 35 years of contributions.

Finally, in July 2007, after lengthy negotiations with coalition leaders and the social partners, the Prodi government introduced a new reform, which replaced the scheme of the *scalone* introduced by the Berlusconi reform for a new "quota" system that mixes age and the years of contributions. In practice, this reform implies a *very* gradual increase of the retirement age from 58 in 2008 to 61 in 2013 (*Eironline* 4<sup>th</sup> March 2008). While the reform was criticized for being too soft by some observers, others have

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<sup>17</sup> The TFR is an end of service allowance set aside by the employer and paid as a lump sum of money upon retirement.

<sup>18</sup> According to this mechanism, employees will have up to six months since being hired to decide whether they want to perceive the TFR at the end of the relationship with the employer or if they want to transfer it to open supplementary private pension plans. In case of no decision ("silence") the TFR will be transferred to the company closed occupational fund, in which the unions usually participate in their management. If such alternative does not exist, the money will be transferred to the INPS.

observed that the government had to cede to the opposition of the more left-wing coalition partners (*Eironline* 4<sup>th</sup> March 2008). Following our theoretical approach, we interpret this reform as another example of how in a context of high political competition, the “political replacement effect” was fairly high, as the probability of the government being punished by extreme left-wing coalition partners was high. Therefore, the government had to agree on a very limited reform.

#### ***d. The politics of pension reform in Greece***

The history of social security in Greece can be traced back to the late 19th century with the emergence of the first social security funds. The development of the Greek welfare state is nonetheless linked to the restoration of democracy in 1974 and in particular the advent of the Socialists (PASOK) in power (1981) leading to the expansion of social policies. Throughout the 1980s benefits rose, eligibility conditions were relaxed for certain categories, while coverage was extended. This expansion further coincided with Greece’s accession to the then EC. The European integration process provided further stimulus to welfare expansion in turn interpreted as a catch-up process with its European partners (Sakellariopoulos, 2007). By the early 1990s Greece had caught up to a significant extent with its European partners; social expenditure measured as a percentage of GDP amounted in 1991 to 21.6% compared to 26.4% for the EU-15 (Eurostat, 2003). However, this exceptional increase in social expenditure exceeded the economy’s capacity causing concerns about its long term financial sustainability (Guillen & Matsaganis, 2000; Katrougalos, 1996; Papadimitriou, 2001).

Central to understanding the pension reform process and outcomes in Greece is the notion of political competition. In particular we claim that while Greece is a typical case of a political system with no veto points, the political replacement effect is high, thereby limiting reform effectiveness or even resulting to the withdrawal of reform

proposals. Governments are faced with strong resistance from both the political opposition (trying to gain the votes of “losers”) and trade unions. In terms of the latter, unions acting as self-interested rational actors defend the interests of their members, thereby pursuing narrow rather than encompassing interests, a strategy that ultimately results in the perpetuation of the system’s inefficiencies and distortions. As highlighted by Matsaganis (2007:545) “the typical unionist is a tenured public sector worker, member of a special scheme, predominantly male, middle-aged and exclusively Greek....while the typical worker is younger, employed (often “flexibly”) by private firms, insured with the general scheme, in an increasingly feminized and multi-ethnic workforce”. Union biased membership composition coupled with the low level of density (close to the European average though but declining) therefore help explain the reproduction of inegalitarian tendencies and the system’s path dependence.

Greece entered the 1990s in a context of severe economic crisis and political uncertainty, making reform unavoidable. The first reform initiatives were undertaken by the Conservative Party (ND). The gravity of the situation was such that fears had been expressed as to the ability of the Greek state to pay pensions and salaries of public sector employees. The case for reform was built on the grounds of containing the soaring costs of pensions (equal to 15% of GDP and amounting to almost half of the overall budget deficit) supporting macroeconomic adjustment, while giving the system some “breathing space” in order to arrive at a consensus as to the basic characteristics of the new one (Matsaganis, 2006). The strong opposition on the part of the trade unions that preceded the passing of the law forced the government (possessing a majority of just one vote) to pass the cost to the non privileged (i.e. those insured with IKA, covering mostly private sector employees) while the “special” funds of public sector enterprises were faced only with minor cuts (Matsaganis, 2006: 164). Public sector enterprises in particular would continue to ensure their personnel with their own funds and not IKA as originally

foreseen. Law 1902/1990 was presented as the first phase of a more comprehensive reform of the Greek system. The key provisions included: increases in contributions, introduction of contributions for civil servants, tightening of eligibility rules for disability pensions, increases in pensionable age and changes in the calculation of pensions. By focusing on the financial aspect, Law 1902/1990 provided a mixture of “housekeeping measures” yet lacked a long term perspective and did not touch upon the structural deficiencies of the system, a hesitation explained by the strength of domestic opposition (Featherstone, 2005).

The second significant reform took place in 1992. The events that preceded the reform (discrediting of government commissioned committee as being hastily prepared, trade unions accusing the government of using the report as a smokescreen, leaking to the press the IMF commissioned report in turn highlighting the severe impact of demographic ageing on public pension expenditure that –in the absence of reform- would escalate to 34,2% of GDP by 2050) culminated in a series of strikes that soon spread from public sector workers, to those in state banks, transport organizations and public utilities. The government, possessing a slim parliamentary majority, was further threatened by some of its party members opposing certain provisions (Featherstone 2005: 742). Under these circumstances, the government shifted the burden on future generations while the interests of those over-represented by the trade unions remained largely untouched. The law unified pension rights and obligations for all public and private sector employees and made them less generous for new entrants to the labor market. The new system strengthened the earnings related character and enhanced intra-generational solidarity through the unification of provisions. Nonetheless, the structural deficiencies of the system were again left untouched (Featherstone, Kazamias & Papadimitriou, 2001). Overall the 1990-1992 reforms were unable to restore the long term viability of the system, while OECD’s projections highlighted the need for further reforms (Mylonas &

De la Maisonneuve, 1999: 25). As argued by Venieris (2006: 77) “reforms came too late and achieved too little”. The “breathing room” provided by the 1992 reform had a 20 year horizon, nevertheless considered as short in actuarial terms.

The Socialist government elected in 1993 based its election campaign on the need for a new social contract; yet it was only after 1996 under PM C. Simitis that pension reform reappeared on the political agenda. No significant reform initiatives were undertaken throughout this period though, while EU’s consent to postpone reform until after the 2000 election gave the government the much needed breathing space. The debate reappeared on the political agenda only after the 2000 elections, giving the Socialists a new mandate under the leadership of C. Simitis. It seems that the pressure exercised by the EU on the Greek government along with its desire to enter the euro-zone, and the recurrent recommendations by international organizations contributed to the strengthening of the case on pension reform (Featherstone 2005: 736).

Projections of the Economic Policy Committee (EPC) on the impact of ageing populations on the long-term sustainability of public finances estimated in particular that the old age dependency ratio in Greece would rise to 54% by 2050 (compared to 26% in 2000) constituting the second highest in the EU-15, thereby causing a significant increase in public pension expenditure as a % of GDP as they would almost double from 12,6% in 2000 to 24,8% in 2050 (EPC, 2001). In addition to sustainability problems the issue of adequacy was also important; old age is still the most important factor in determining risk of poverty despite the significant part of GDP being absorbed by pensions. A further weakness related to the system’s fragmentation and legislative complexity resulting in the unequal treatment of similar cases (Council EU, 2003: 113-114).

Following the failed reform attempt of 2001 that entailed a heavy cost to the government as it aggravated conflicts within the Socialist Party, affected the PM’s popularity, increased mistrust towards the government (the latter considered as an

important factor that contributed to the Socialists' subsequent electoral defeat) and widened the gap with the trade unions, a new reform initiative was undertaken in 2002 (Sakellariopoulos & Angelaki, 2007). This was seen as the government's last opportunity to bridge the differences and regain the citizens' and trade unions' trust, while sending a message to the European Commission and international organizations regarding the government's readiness for undertaking reforms. Following lengthy consultations with the social partners and the radical reformulation of the 2001 proposals a new reform was approved in 2002.

Law 3029/2002 was portrayed as containing measures that contributed to the attainment to the objectives of adequacy, financial sustainability and modernization. In particular, viability was expected to be achieved through the guarantee of an annual state supplement equal to 1 % GDP up to 2030. In terms of adequacy, measures included the equalization of minimum pensions and the provision for a common replacement rate (by eliminating the provisions of 1992 that differentiated between "old" and "new" entrants). The differentiation of the roles of primary and auxiliary pension, with the state having henceforth a reduced role in auxiliary pension would make it easier to cater for individual preferences. Under the modernization objective the introduction of funded occupational pensions was presented as an element adding flexibility to the system (MEF/MLSS, 2002). Sotiropoulos (2004: 277) argues that the introduction of funded schemes can be considered as a hesitant step towards a multi-pillar pension system, as the ones adopted in other EU states. However, this new element has hardly resulted in a change in the original structure of the system; the gradual transformation of auxiliary funds into funded occupational schemes managed by the social partners has not been realized, while the four occupational funds that have been established are limited to the provision of either lump sum payments or health benefits (Romanias, 2006: 356). Studies by the trade unions' Labor Institute have also questioned the annual state's supplement adequacy in

guaranteeing IKA's future sustainability, especially as the government is not upholding to its part of the agreement (Robolis et al. 2007). The successful outcome of the 2002 reform stands in sharp contrast to the 2001 experience. Yet, the consensual approach adopted ultimately undermined the overall effectiveness of the reform that required further efforts (Council EU, 2003; Featherstone and Papadimitriou, 2007).

Following the 2004 elections and the advent of the Conservative Party in power, the launch of a social dialogue process was announced on several occasions. However, initiatives were undertaken only after the party's second electoral victory in 2007 (possessing a slim majority though). The reform process that culminated with the passing of Law 3655/2008 was initiated with the establishment of an Experts' Committee (Analytis Committee) with a mandate to study the system and its prospects. The Committee submitted however its final report (October 2007) well before the ILO commissioned actuarial study was completed (January 2008). The Report highlighted the impact of a series of factors (legislative framework, employment/unemployment levels, GDP growth, demographic trends, migration, contribution evasion) on future expenditure and provided a set of measures (among others strengthening of employment, combating contribution evasion etc) in an attempt to limit the future rise of pension expenditure (Analytis Committee, 2007). Even though doubts have been raised concerning the social dialogue that followed in the Greek Parliament, Law 3655/2008 was finally voted in March 2008. Law 3655/2008 is divided in two parts; the first deals with organizational and administrative aspects, -entailing measures on the unification and merging of funds that will limit the total number of pension schemes from 155 to 13- while the second contains measures aimed at the rationalization of specific provisions. It is of interest to note that the Preamble of the Law does not make any reference to the above-mentioned reports or data. The reform initiative is justified by reference to the need to limit the system's fragmentation and demographic prospects. The unification and merging of funds

is undoubtedly an important step contributing to the system's rationalization. But as merged funds retain their original provisions, serious concerns are raised about the extent at which the unification and merging can cure existing distortions. In parallel, given the absence of actuarial studies, doubts have also been raised regarding the extent at which the measures enacted are well grounded (Angelopoulou, 2008).

Featherstone and Papadimitriou (2007: 113) have characterized ND's first term in office (2004-2007) and in particular their record on pension policy as displaying limited ambition and inconclusive results. Guillen and Petmesidou (2007) on their part interpret this reluctance as an attempt of the government to buy time and find a more suitable moment for the introduction of a reform that according to them would entail the strengthening of the second and third pillars. The outcome has fallen short of their expectations though, as the 2008 law is limited to a restructuring of the first pillar. At the same time the EU and the OECD have already stressed the need for the introduction of new measures, such as the introduction of disincentives for early exit from the labor market, the strengthening of the link between contributions and benefits, the adoption of a more narrow definition for categories benefiting from the arduous-work clause, the access to disability pensions strictly on medical criteria (Council EU, 2008a and 2008b, OECD, 2009). As pointed out in OECD's latest economic survey on Greece social security funds contribute heavily to the recurrent expenditure overruns, while lacking a hard budget constraint. In addition, the high long-term pension liabilities have contributed to some extent, according to the OECD, to the increase in the government bond spreads vis-à-vis Germany (OECD, 2009).

#### ***IV. Discussion and conclusion***

The four countries under study have engaged since the early 1990s in a series of reform initiatives that -following closely on the path observed in other European countries- have resulted in the reduction of the generosity of the public pension pillar, the

promotion of supplementary pension provision and the guarantee of adequacy through the introduction of minimum income schemes that were until recently absent from these countries (Greece still being an exception). While reforms have been enacted following a series of socio-economic pressures that have placed significant pressures (albeit to varying degrees) on the future financial sustainability of public pension systems, the four countries under study display different reform records. In particular, while Italy has enacted more path-breaking reforms, the latter have been more modest in Spain, whereas pension reform has largely stalled in both Portugal and Greece.

The analysis of the factors contributing to such divergent outcomes has highlighted the role of structures, political competition and organized labor and in particular the way their interaction impacts on reform outcomes. In particular, the mechanism of political competition as elaborated here by utilizing the concept of “political replacement effect”, which makes reference to the probability that potential losers from reform measures will be able to punish the current government by withdrawing their support in upcoming elections or by pressuring parties to withdraw the support for the reform measures in Parliament, is useful to understand the logics of pension reform in Southern Europe.

In Italy, the technocratic governments of Amato (1992) and Dini (1995), feeling less dependent on the support from political parties to elaborate their far reaching reform projects, succeeded in passing significant reforms. However, reform effectiveness has been curtailed due to the concessions made to the labor movement in return for their consent. Union opposition has also proved an important factor during the Berlusconi reform in 2001. On this occasion Berlusconi proposed a significant reform plan, facing a low replacement effect given the majority obtained by his party in both the Chamber of Deputies and the Senate in 2001. However, he was forced to hold back from his original ambitious reform plan due the severe opposition on the part of trade unions.

The Greek case stands in sharp contrast to the Italian one and could therefore be placed on the opposite extreme of the reform evaluation scale; successive governments since the early 1990s have been unable to overcome union opposition and have therefore engaged in “housekeeping measures” providing a breathing space until the next round of reform initiatives. At the same time, unions’ biased composition and their perception of reform initiatives as a zero sum game –a fact explaining their strong opposition- have resulted in the perpetuation of the system’s distortions. The high “political replacement effect” given by the tendency of “losers” to curtail the support of legislators to block reform measures also helps to understand why reforms efforts have usually stalled.

In between these two extremes stand the cases of Spain and Portugal. In Spain, the PSOE government in 1986, enjoying a strong parliamentary effect and facing a weak opposition, was able to pass a significant reform that re-organized the system, increased the number of years for the calculation of benefits and eliminated fraud. Since the 1990s, however, the issue of cost-containment reforms has become more critical and more dependent on the logics of political competition. Thus, fearing a high replacement effect, governments have usually negotiated moderate reforms with some significant concessions for the labor movement. The case of the former successive governments feeling threatened by the political replacement effect has engaged in more moderate results.

By contrast, and just like in the Greek case, reform in Portugal has been usually hard to achieve and some significant measures have fallen short of being implemented. Nonetheless, the PSD government in 1993 and the PS one in 2007 were able to pass important reforms enjoying significant parliamentary support and less favorable structural economic conditions. However, in both cases the resistance of civil servants and trade unions to eliminate specific privileges (such as the “plafonamento” issue) have undermined the long term effectiveness of such reforms.

Our comparative analysis has then shown the validity of re-employing some of the approaches to pension politics and political economy that have been employed elsewhere. Our analysis shows that socio-economic structures are important in determining the need for reform, while the role of the labor movement is important in determining whether they accept specific concessions to allow for significant reform to be passed. However, the role of political competition, (as first introduced by Anderson and Immergut 2007) has proved to play a significant role in the logics of reform in these countries. In this sense, building on the concept of “political replacement effect” as elaborated by Acemoglu and Robinson (2002), we have been able to explain in more depth how the logics of political competition, in combination with structural conditions and the role of the labor movement, play a significant role in the domestic mechanism of pension reform in Southern Europe.

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