POLÍTICA COMPARADA

Insiders vs. Outsiders:
Distributive implications of pension policies in increasingly flexible labor markets

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As most other European countries, Spain faces the challenge of securing old age pensions in times of a two-fold, contradictory pressure: on the one hand, fiscal austerity requires pension cutbacks, whereas at the same time, the spread of atypical employment and unemployment creates new social needs of labor market outsiders. Both sources of pressure are particularly acute in Spain given the insider-focus of its traditional pension regime and the dramatic changes in labor market prospects especially for the younger generations. Balancing the pension rights of insiders and outsiders has thus become the linchpin especially for Social Democrats, since they defend the privileges of the traditional insider-constituencies while at the same time advocating generational solidarity and redistribution. The Spanish pension reforms so far have been ambiguous in their effect on insider-outsider redistribution. While the reforms of the Toledo pact raised minimum pension levels, the 2011 reform will deepen insider-outsider divides by strengthening the link between contribution-records and benefits. Finally, several issues have become salient on the reform agenda in other European countries, but seem somewhat neglected so far in Spain: a reduction of civil servants' pensions, increased tax-financing, contribution-payments for the unemployed and a more progressive implementation of pension cutbacks.

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> *The reduction of old age poverty thanks to encompassing old age pension systems is one of the key success stories of the post-war European welfare state. However, the success came at a very high cost*

Until the 1970s, old age was the most important poverty risk throughout Europe. From close to 40% of the elderly population, income poverty levels fell to little over 10% on average in Europe (OECD 2008) as a result of pension replacement rates of around 70% or more on average. The reduction of old age poverty thanks to encompassing old age pension systems is thus one of the key success stories of the post-war European welfare state. However, the success came at a very high cost. No less than 6.4% of GDP on average are spent annually on old age pensions in Western Europe. In comparison, expenditures on labor market policy (active and passive policies combined) correspond to "only" about 1,3% of GDP in 2008. Furthermore, pension spending is still increasing dramatically because of the ongoing wave of retirement of the baby boomer generation and the low fertility rates among subsequent generations. The economic slowdown and the multiple crises that have hit Europe since the 1980s have only added to the financial strain on pension regimes. Hence, there is no wonder that the policy reform debate on the welfare state is dominated by pensions, and that the pension reform debate is dominated by the need for financial consolidation, benefit cuts and retrenchment. In this context, Social Democracy generally focuses its efforts on defending existing pension levels or at least moderating cuts.

However, in the loud debate on pension retrenchment, it remains all too often overheard that financial strains are not the only reform challenge pension regimes confronts (Häusermann 2010). Post-industrial labor markets have led to a spread of discontinuous, atypical employment (mainly part-time and fixed term) and (long-term) unemployment has been looming large in Europe since the 1980s (Esping-Andersen 1999). Since the level of pension benefits an individual receives after retirement is in most countries closely connected to the amount of contributions he/she made during his/her work-life, this transformation of labor markets has created new poverty risks, as more and more people are unable to fulfill the eligibility requirements for a full pension. Therefore, even a very generous "full pension level" may mask distributive problems, if this full pension becomes out of reach for ever larger parts of the society. In this context, one speaks of "insiders and outsiders": insiders are those in stable, typical employment to whom the standard pension level applies. Outsiders, by contrast, are those with weak or interrupted labor market attachment, to whom regular pension levels do not apply and whose old age security mostly depends on non-contributory, means-tested benefits.

The challenge of pension reform today is to balance the pension rights of insiders and outsiders in a context of financial strain and austerity. In the following, I would

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like to point out briefly the ''distributive options'' that exist throughout Europe, and why the abovementioned challenges are most acute in continental and southern Europe. I will then discuss the general reform trend most continental European countries have been following over the past two decades, before turning my eyes to Spain more particularly. I will argue that retrenchment pressure and the ensuing distributive dilemma between insiders and outsiders is particularly strong in Spain. Recent reforms have had ambiguous effects on the distributive effects of the Spanish pension policy. While reforms in the 1990s (the Toledo Pact) and in 2004/5 have shifted the balance slightly in favor of labor market outsiders, the most recent 2011 reform risks to widen the insider-outsider gap again. Given the exceptionally high levels of atypical employment and unemployment, especially among the young in Spain, dealing with old age poverty of labor market outsiders will be the biggest challenge in Spanish pension policy in the future. I will close with a few remarks on possible strategies to tackle this and other problems.

Pension regimes can be classified roughly into three types, depending on the criteria of eligibility, the distribution of benefits and the mode of financing. In *universal* pension systems, which can be mostly found in the countries of Northern Europe, pension schemes are strongly financed through income taxes and benefits are progressive. This means that people with lower incomes enjoy significantly higher replacement rates in the public pension regimes than people with higher incomes. Since pensions are strongly tax- instead of contribution-financed, benefits are less tightly linked to labor market participation and thus insider-outsiders divides are weaker than in systems where this link is strong. All systems have their advantages and disadvantages. In the case of Nordic pension regimes, the main advantage is that it entails low old age poverty and strong equality among the elderly, and that the financing of pensions relies on a very broad, stable tax base. The disadvantage, on the other hand, is to be found in the high cost of these schemes, which is a reflection of its redistributive character. The *liberal* pension system is similar to the Nordic one, but at a much lower level of benefit generosity. In countries such as the UK, Canada and the US, the public pension benefits are progressive just as in Denmark and Norway, but instead of replacing between 80 and 120% of the former income for low-income people and between 60 and 80% of the former income for higher earners, the replacement rates are at around 60 and 30-40% for lower and higher earners respectively (OECD 2011). Financing is mostly based on income taxes, as well, and eligibility is generally means-tested, i.e. it depends on an individual's needs, not his or her contribution record. All these regimes provide strong opportunities for higher income classes to exit the public pension scheme and buy pension insurance with semiprivate and private insurance companies. This entails the problem of low levels of solidarity within the public scheme. Given the low level of public pension benefits for all citizens, irrespective of their employment status, the insider-outsider gap is not very strong in the liberal countries, and pension policy typically reduces this gap even further (Häusermann and Schwander forthcoming 2011).

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Finally, the social insurance pension schemes that can be found throughout *continental and southern Europe* are the most problematic in terms of insider-outsider divides. This is due to the close link these schemes establish between benefits and contributions, i.e. between what an individual contributes during his/her work-life and the benefit entitlements he/she has earned with these contributions. The tight link between contributions and benefits is the result of the fact that pension regimes in these countries have been traditionally controlled and managed by the social partners (trade unions and employers) rather than by the state, and it also stems from the fact that the financial resources of pension regimes are almost exclusively based on contributions (rather than taxes). These systems are *insurance schemes* in the real sense of the term, i.e. they insure the risk of income-loss proportional to this income, which implies that higher earners receive higher pensions after retirement than lower earners. Therefore, benefits are usually not progressive, but proportional or even regressive. Insider-outsider divides are strongest in these contributive systems, since weak labor market integration directly affects pension levels. Therefore, pension rights are highly unequal between insiders and outsiders, and this feeds into strong gender and generational divides based on labor market attachment (Häusermann 2010). Yet, insufficient outsider protection is not the only problem these systems face: their mode of financing (through payroll taxes) is unsustainable in times of weak economic performance, since it subtracts resources to the system precisely when those are needed most, which is why retrenchment pressure is highest in these schemes. This combination of new demands and financial austerity creates acute distributive struggles between insiders (who defend their pension levels at the core of the system) and outsiders (who need better protection at the margin of the system). Governments and political parties, especially on the left, face difficult trade-offs in this situation: insiders are the traditional constituency of social democratic parties and trade unions, which is why they tend to defend existing pension levels (Häusermann 2010b). At the same time, continued generosity regarding these core pensions comes at the price of poverty risks for outsiders (today's most vulnerable social group), since means-tested benefits cannot be expanded without significant cutbacks of core pensions. Caught in this trade-off, most European governments

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have actually cut back on core insider pensions, while granting compensations for the cutbacks to selected groups, outsiders but not exclusively.

A review of pension reform in Europe over the past two decades shows a striking trend: almost all countries have significantly cut back their standard pension levels (OECD 2011). They have done so through (a mix of) different means, such as rising the retirement age and cutting full pension levels (e.g. Germany, Switzerland, France), increasing the number of contribution-years required for an full pension (e.g. France, Spain, Italy, Belgium, Austria), by changing pension indexation from wages to prices (e.g. Germany, Netherlands) or by severely limiting the possibilities of early retirement (e.g. Italy, France, Austria). What had seemed unlikely or almost impossible a few years earlier became reality throughout Europe from the mid-1990s onwards: pension levels were severely cut. Until then, it had been argued that such cuts were unlikely to happen, since a majority of the population would be hit by them, would thus oppose them and thereby would turn pension retrenchment in such an electoral risk that no government would dare to touch pensions (Pierson 1996). So why did pension retrenchment happen nevertheless?

The answer is that governments implemented reforms successfully when they were able to compensate important social (and electoral) groups for their losses. Compensation and political exchange have become a necessary condition for pension retrenchment (Häusermann 2010). The specific groups of beneficiaries who were compensated vary from country to country. Indeed, compensations can go to insiders or to outsiders. In some countries, compensation for retrenchment comprised elements such as very long transition periods for the elderly generations or early retirement for core workers with long careers (e.g. in Italy in 1995 and in France in 2003). Such reforms obviously widen insider-outsider gaps, since the entire cost of retrenchment remains with the younger generations that have weaker labor market attachment and thus weaker contribution records anyway. In other countries, however, governments chose to compensate outsiders, by introducing improved minimum pension schemes and "virtual" pension contributions paid by the state for periods of non-employment (e.g. for reasons of child rearing, training or unemployment). Germany is a typical case in point: in its 2001 and 2004 pension reforms by the left-wing government, it implemented harsh cutbacks for general pension levels, but at the same time, it introduced a universal, tax-financed minimum pension scheme that distributes pensions based on needs rather than contributions. Germany also improved pension rights of women who drop out of the labor market for periods of child rearing, thereby compensating typical

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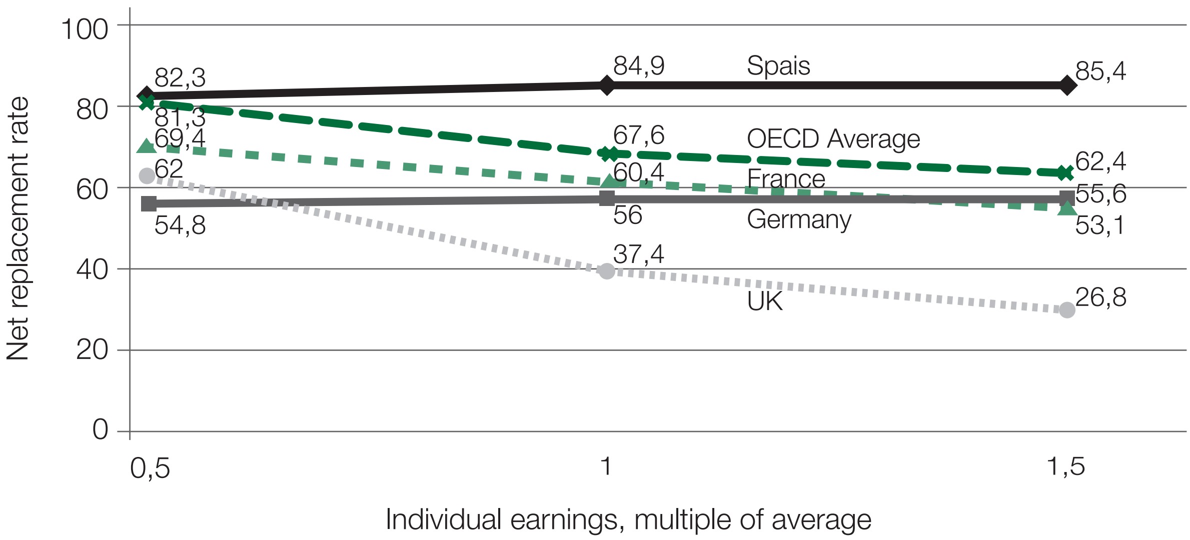
outsider groups. The problem with this strategy is that outsiders are an almost naturally weak group in political power terms, since they tend not to participate in elections and are very weakly organized in parties and unions (Häusermann 2010). Hence, to bolster reforms with political support, the German government also introduced strongly subsidized, voluntary semi-private pension schemes, which are particularly attractive for higher middle class and upper class earners. In that sense, the German government achieved stronger outsider support at the lower end of the income distribution, at the cost of increased inequality at the upper end of the income distribution. The main losers of the German pension reform were middle-class insiders, whose pensions dropped, but who have not enough savings to accumulate substantial private pension rights. However, one must keep in mind that these were exactly the groups who traditionally had very generous pension rights, i.e. their pensions were cut at a high level. In that sense, Germany lowered the insider-outsider gap of its pension scheme by compensating outsiders for retrenchment of general pension levels.

This short description of European reform trends, and the case of Germany in particular, illustrates well the difficulties and dilemmas the European Left faces in today's pension policy. As the funds are getting scarce and not all clienteles can be served, hard choices need to be made. They need to be made both with an eye on the electoral and political implications and with an eye on their distributive consequences in terms of inequality and poverty.

The situation in Spain has been and still is typical of the continental European situation, but with all the continental characteristics and problems further amplified. Let us begin with the traditional setup of the Spanish pension regime: it developed as a typical contribution-financed, pay-as-you-go pension insurance regime since the 1960s, highly fragmented in more than 50 insurance schemes in the beginning and moderately consolidated to about 7 regimes by the early 1990s (Chulià 2007). As in most continental countries, civil servants' pensions are paid out of a distinct scheme and are particularly generous. Private pension schemes are still very marginal, accounting for not even 10% of pension payments. One particularly striking aspect of the Spanish pension scheme is the exceptionally high level of full pension replacement rates. Figure 1 shows net pension replacement rates from public (and mandatory private, of which there are none in Spain) pension plans in Spain and a few comparative cases. As can be easily seen, Spanish replacement rates are high, particularly when it comes to medium and higher income levels. People earning 1,5 times the average income over their life course can expect a replacement rate of 85% if they have contributed all the time to the pension scheme. This is exceptionally high. The fact that replacement rates even go slightly up when moving from lower to higher average income levels shows that pensions in Spain are clearly not progressive. This means that the pension insurance scheme does not redistribute resources from the rich to the poor. Rather, each contribution-payer accumulates rights that are proportional to his or her previous earnings. Figure 1 also shows that in comparison the OECD average, French pension levels and in particular UK pension levels are clearly progressive. German public pensions, by contrast, are proportional (similar to the Spanish case), but at a significantly lower level.

Figure One: Net pension replacement rates from public and mandatory private pension plans (for workers with a full contribution-record)



Source: OECD 2011

What figure 1 does not show is that these generous pension levels apply only to a part of the workforce, i.e. to workers with a full contribution-record of 35 years (38,5 since the 2011 reform). Outsiders who have interrupted careers or who start contributing only very late to the system will not be able to accumulate this full contribution record. Hence, their pensions will not reach the generous level displayed in figure 1. And this is where the structural challenges that Spain confronts come in. The stark spread of atypical employment (especially fixed term) and youth

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unemployment - at levels around 40% depending on the region - make it crystal clear that most members of the younger generations will not be able to accumulate sufficient contributions. Hence average replacement rates will be much lower than the ones set by law and means-tested minimum pensions will acquire increasing importance. The alarming trends in the Spanish labor markets regarding unemployment and atypical employment among the younger generations, as well as the traditional social insurance set-up of the pension system point to the fact that balancing distributive implications for insiders and outsiders is *the* challenge for the Spanish pension system.

Reforms so far have been ambiguous in this respect. On the one hand, minimum pensions have been strongly increased since they were first created in 1990. With reforms in 1997 and 2004/2005 (following the Toledo Pact in 1995 and the government turnover in 2004), the level of minimum pensions was increased and is not at 32 or 39% percent of average earnings, depending on whether the recipient has to care for dependents. This improvement of means-tested pensions, which do not depend on contribution-payments is crucial in terms of insider-outsider divides. Also, the structure of the pension system has been adapted in 1997 to account for the increasing importance of the non-contributory benefits: with the introduction of a pension reserve fund in 1997, the sources of financing of contributory and non-contributory benefits were clearly distinguished also in institutional terms. Yet, the minimum pension remains clearly below 50% of median earnings, i.e. below the standard poverty level. Parallel to the improvement of minimum pensions, the rather generous standard pensions have been cut back only rather timidly until recently, so that the OECD in a 2003 country report urged strongly for changes in entitlement (Chulià 2007). The 2011 pension reform has implemented precisely this: with this most recent reform, the projected pension replacement rate for (full-career) insiders will drop to about 73,9% (OECD 2011b), which is still high in the OECD average, but considerably lower nevertheless. Savings by this reform are estimated to be very substantial. Figure 2 shows that projected pension expenditures should drop to little over the OECD average by 2050, which would be lower than expenditure in France, Italy or even Germany.

At the same time, this reform will have strongly negative effects on insider-outsider divides, since it is supposed to reinforce the link between contributions and benefits. The required contributions-years for a full pension are increased to 38.5 years, which means that the impact will be strongest for people with interrupted careers or with short careers. For people with only 28,5 years of contribution, for

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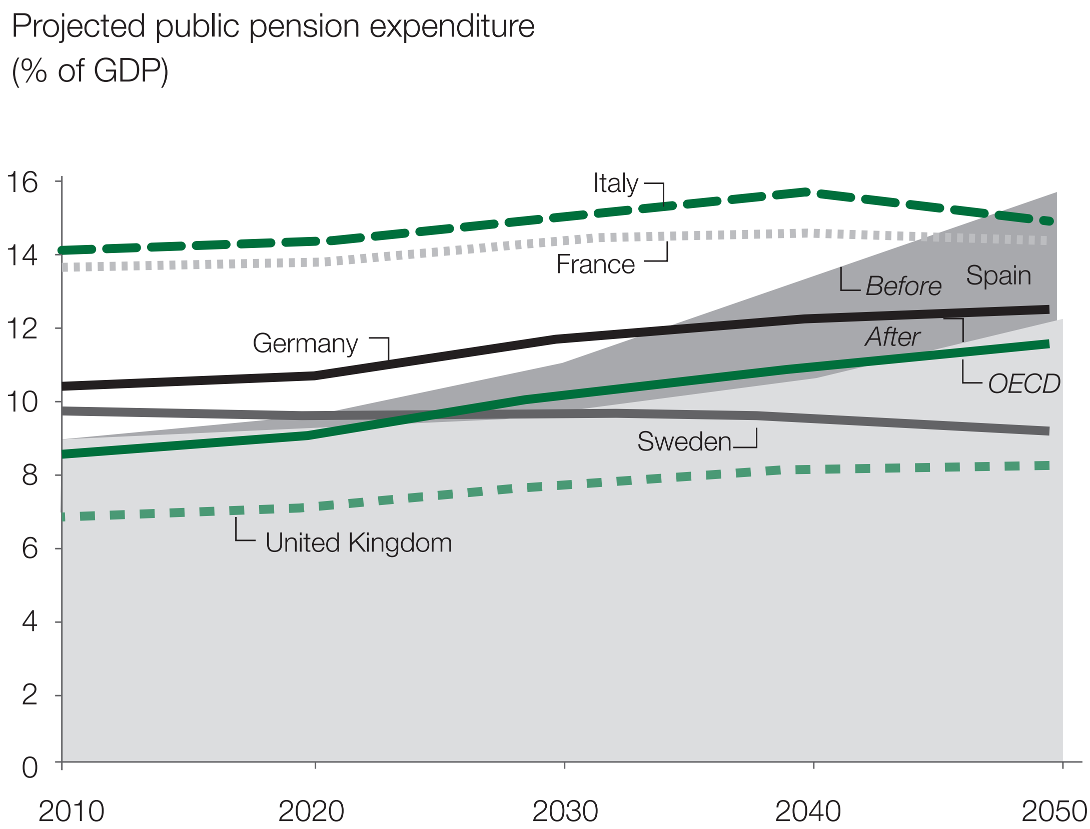
Figure two: Projected pension expenditures, 2010-2050



Source: OECD simulations based on Government of Spain briefing (OECD 2011b)

instance, replacement rate will fall to 70%. Hence, the key question is to what extent periods of non-employment (unemployment, sickness, maternity and paternity leave, training etc.) are covered in the pension system. For maternity and paternity leave, there is a 2 year coverage, which means that contributions are paid by the state as if the individual did have an income. For the unemployed, however, the government pays only 35% of the pension contributions, whereas the employee would have to shoulder 65% him- or herself. Given Spain's levels and duration of unemployment, this is a serious problem which may lead to additional pressures in terms of old age poverty and in terms of the number of people relying on minimum pensions.

In conclusion, I would like to mention a number of issues that have been salient on other countries' reform agendas, but seem to have gained surprisingly little attention in the

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Spanish reform debate. The first is the still generous level of civil servants' pensions and whether pension rights should not be harmonized between civil servants and employees. Generous civil servant pension schemes typically contribute to strong insider-outsider divides and thus they have become major areas of reform in countries such as France or Italy. Second, the increasing reliance of old age income security on non-contributory benefits might have to go together with a clear shift from contribution- to tax-financing, in order to widen the tax base and relieve the burden of payroll taxes on wages. Third, in light of the instability and vulnerability of the Spanish labor market, pension credits for the unemployed are crucial. In Germany, for instance, the state pays 80% of previous pension contributions for the first year of unemployment, much more than is the case in Spain. Finally, one may want to start thinking about making the public insurance system more progressive, i.e. lowering pension levels more strongly for higher income classes than for the lower ones. This would, of course, imply a shift away from the traditional insurance principle, but in times of post-industrial labor markets and financial austerity, this insurance principle has in many ways become largely dysfunctional anyway.

> *Compensation and political exchange have become necessary conditions for pension retrenchment.*

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