

# **European pensions and global finance: continuity or convergence?**

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**Abstract.** The retirement of the baby boom generation is a profound threat to the structure and organisation of continental European retirement systems. Whereas the German financial system, for example, has been often favourably compared to the Anglo-American system of corporate governance, it is argued in some quarters that it will have to become far more "American" if current living standards are to be maintained. The paper begins by suggesting that these issues should be taken seriously by economic geographers; we have a distinctive perspective that should not be lost in the more general debate. Subsequently, the paper focuses on three threads or themes. Why the demographic crisis is a crisis not just a transition; why global finance is deeply implicated in any European solution to the demographic crisis, and; whether continental European countries will be able to maintain their inherited retirement income systems in the face of competition from the Anglo-American model. Unfunded social security benefits threaten the economic welfare of all citizens; those that will be retired and those that will continue working over the next 20 to 30 years. Proffered solutions tend to rely upon the market rather than the state, and tend to match or mimic Anglo-American financial practices. This does not mean that continental Europe need converge upon the Anglo-American system of finance and retirement income provision. But it does seem highly likely that continental European countries will seek solutions that draw upon aspects of this system. Rather than thinking of convergence to the Anglo-American model as the most likely outcome, and rather than thinking of continuity of difference between systems as a viable scenario, European countries will in some way or another be forced to seek accommodation with global finance. Whether continental Europe will be able to hold global finance at bay remains to be seen. Global finance may penetrate national economic and social systems far deeper than ever intended.

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## **Epigraph**

"For all its success, it is unlikely that the US offers the only workable way to organise an advanced economy. It is also questionable how far other countries could replicate all aspects of its way of doing things, even if they wanted to. Its history makes the US exceptional.

Nevertheless, it is also evident that in the sweep of history, all successful economies will continue to become more 'American'. Information becomes ever freer; interventionist states are relaxing the reins; markets and contracts substitute for relationships and hierarchies; formal regulation replaces nods and winks; and welfare states are cut back.

The US does not offer a model that can (or should) be replicated in its entirety. But as has been the case for much of the last hundred years, it does set the standards by which other countries are judged." Wolf (2000, page 25).

## **Introduction**

One of the most difficult issues confronting advanced Western economies is the looming retirement of the baby boom generation during the first half of the 21st century. While an issue of profound demographic, social and political importance it is, inevitably, also an issue of enormous economic significance. This has been widely recognised by academic and policy-related commentators (see Disney 2000; World Bank 1994). Not surprisingly, there has been a steady stream of research devoted to demographic trends and their economic and social implications; witness the leading research undertaken and published by the OECD (1998, 2000) and its staff (Leibfritz et al. 1995) on behalf of member countries. In this paper, I comment upon and make reference to this and other related research, emphasising its significance as well as the interaction between European demography and global finance. See, for example, recent comparative research on pension systems (Clark 2001a) and the causes and consequences of early-retirement for the funding of social security in continental Europe (Gruber and Wise 1999).

To illustrate, a recent French government report summarised the problems facing France in paying for forecast social security liabilities (Charpin 1999). By 2040 there could be 7 retirees for every 10 workers (compared to 4 retirees for every 10 workers during the 1990s). In effect, those working will have to carry twice the burden of those not working compared to the current generation of working people. In terms of expected financial commitments, it was estimated that by 2040 retirement benefits will account for more than 18 per cent of French gross domestic product (GDP) compared to the current (1998) rate of approximately 12 per cent of French GDP. As we shall see, this would be a very large burden on the French economy compared to the UK and US economies (but not Germany or Italy). Furthermore, it was estimated that by 2040 the Pay-As-You-Go (PAYG) social security system deficit could be as much as FF700 billion if unemployment were to average 6 per cent over the first 40 years of the 21st century. Given the relatively poor performance of the French economy in terms of unemployment over the last three decades, few analysts are confident that such a scenario can be avoided. Reform of French labour markets, capital markets, and retirement systems maybe the only viable option (Gardiner 1999).

The near-term future of France is apparently shared to varying degrees by other large continental European countries. By contrast, the Anglo-American world

appears less concerned about demography and public finance. For the US and the UK, more often than not concerned about the proper balance between government and private provision of retirement income, the benefits of market provision rather than the threats posed by demography have been at the core of public debate. In the US, the debate about privatising social security is as much a debate about the importance of individual autonomy as it is a debate about the optimal long-term pension financing and investment (see Aaron and Shoven 1999). In the UK, the minimum value of state-provided pensions is mediated by the powerful contemporary role of individual savings and employer-provided supplementary pensions (Budd and Campbell 1998). As in many other countries, public pension obligations are not fully funded in the US or the UK. Even so, the importance of the private funded sector has not only rendered debate about demography trends less significant, the role of Anglo-American pension funds in global financial markets has been perceived as a powerful factor driving comparative economic advantage in relation to European rivals (Clark 2000).

For continental Europe, the demographic time bomb is a crisis of confidence in their national systems of social welfare, finance, and corporate governance (Bonoli 2000). Many commentators question whether continental Europe has the political will and economic resources to resolve this crisis. Fealty to inherited models of inter-generational social solidarity may be impossibly expensive while capitulation to the Anglo-American model of economy and society would seem to imply acceptance of levels of risk and inequality at odds with continental political traditions (Bonoli et al. 2000). Pressures for reform of European pension and retirement income systems are (internally and externally) significant and insistent. However, as the German case shows, reform is highly contested being subject to shifting political alliances and the entrenched interests of organised constituencies (Mantel and Bergheim 2000). The way forward is unclear. Some commentators deny the need for reform, arguing instead for the prospects of economic growth (Dupont and Sterdyniak 2000). Others cling to the principles of social solidarity, arguing that reform must reconcile new models of retirement financing with past commitments to social solidarity. Yet others see adoption of the Anglo-American model as the solution to both adverse European demography and lagging economic performance (a notion widely disputed; compare Borsch-Supan 2000, Orszag and Stiglitz 1999 and Taverne 2000).

This paper is about the contested world of European pensions, and the tensions between continuity (with the past) and convergence (with respect to the Anglo-

American model). One goal of the paper is to show how and why European pensions are an important topic for economic geography. In doing so, I argue that demographic imperatives may be as important as the new economy for Europe through the 21st century. A second goal of the paper is to show that the principles of social solidarity remain very important in European debate over national systems of retirement income and finance. A third goal of the paper is to articulate the connection between the demographic crisis and global financial markets. Official solutions to the crisis may involve the dismantling of nation-specific systems of finance and retirement income in the favour of financial capitalism. To put it plainly, and in relation to Wolf's (2000) suggestive argument, Deutschland AG may be "reformed" according to Anglo-American terms and conditions (Nocker 2000). Finally, I raise questions about the proper role of markets in relation to social solidarity in regulating the provision of retirement income, noting the very different conceptions of risk allocation and risk management.

Before proceeding, I should set out my argument and its implications. With respect to continental European PAYG social security systems, I argue that these systems are not economically sustainable: the combination of demographic imbalances, the costs of early retirement and under-funding require a high long-term real rate of growth at odds with past macro-economic performance. Demography looks likely to overwhelm the inherited social welfare systems of European nation states. I also argue that the Anglo-American model poses a serious threat to the past, offering a means of pension funding and economic development that has many desirable features given the growth of the new economy over the 1990s. But, of course, the Anglo-American model brings with it market risks and income inequalities at odds with continental European social welfare traditions. Indeed, it may not be politically sustainable over the long term (Mantel 2001). Even so, it should also be recognized that European solutions to the demographic crisis that would discount the future value of pension benefits may be very destructive of social solidarity within and between the generations. It seems inevitable that solutions to the demographic crisis must come to terms with global finance; unresolved at present is whether such solutions will accommodate with or converge to the Anglo-American model.

## **Demography and Economic Geography**

Demography and its various components including migration have been staple topics of geography and related sciences for many years. Of course, much of the European work on this topic has focused upon the urban, regional and the international scales, less so national demographic trends in their own right (see Fassman and Manz 1992). Obviously there are distinct local, regional and national trends behind the forthcoming retirement of the baby boom generation that deserve further scrutiny and analysis. For instance, it appears that the UK and Ireland and the US will be less affected by ageing than continental Europe just as southern England and the western US will be less affected than the north-east of both countries. Furthermore, immigration over the past 30 to 40 years has so altered the US demographic profile compared to its European cousins that talk of a demographic crisis seems abstract and exaggerated.

Just as importantly, in terms of the location of economic activity it is a commonplace observation that the competitiveness of firms depend upon "local" cost structures including retirement benefits (Clark 1993). Much of the relevant literature has focused upon inter-regional wage disparities, and the role of labour market processes including migration in balancing local capital and labour markets (Martin 2001). As European economic integration develops, it is increasingly apparent that inter-regional wage dynamics will be closely related to national systems of the social wage. Indeed, the principal components of the social wage may overwhelm "local" variations in wages, labour productivity and supply transforming the spatial scale of corporate location decisions from the region within the nation to the nation and Europe beyond. Equally, as economic geographers have been empowered by the new significance attributed to regional clusters of innovation, it is increasingly apparent that the vitality of such clusters depends a great deal upon their national location for finance and market access. Making the connection between regional growth and national systems of finance is a vital task for economic geography (see Tickell 2000).

Whereas the new economy could be seen as a technological phenomenon, it is also a financial phenomenon being driven by venture capital, stock-options, and IPOs. Behind the new economy are financial intermediaries, institutional investors and pension funds (Aglietta and de Boissieu 1997). The importance of these institutions has not been lost on European policy makers. Recent initiatives by the European Commission assume that a necessary condition for economic innovation is the existence of large pools of risk capital. Thus, the promotion of European capital

market integration and the introduction of new types of market participants and financial relationships are perceived to be necessary steps of reform. Inevitably, some European policy makers see the financial imperatives driving the new economy and the looming demographic crisis as much the same issue: perhaps to be resolved by the adoption of Anglo-American funded pension institutions (Bolkestein 2000). This is, of course, a very contentious view. The recent discounting of the market value of internet stocks, for example, has alarmed many Europeans reinforcing their distrust of markets--the risks inherent in speculative bubbles seem most inappropriate when planning future retirement incomes (Shiller 2000).

Of course, there has been considerable comparative work on national pension and social welfare systems. Esping-Anderson's (1989) typology of advanced welfare systems in relation to social stratification remains a major reference point for those concerned about the shape and evolution of social welfare policy. Similarly, the more recent cross-country study by Goodin et al. (1999) evaluating the effectiveness of different countries' social welfare regimes reminds us of the deeply embedded nature of social and political institutions. Both studies make explicit the connection between institutional design, moral values and national regulation. At the same time, both studies are pre-occupied with the continuity of difference as if the institutions of social welfare policy match and reinforce profoundly different national moral and political cultures. By contrast, Bonoli et al. (2000) reminded us that national welfare systems are also affected and "regulated" by the corrosive effects of globalisation. Indeed the presumed embeddedness of economic agents and institutions is a most fragile concept, being highly vulnerable to countervailing forces of global economic competition and integration (Streeck 1997).

Clearly, there is enormous value to be had in a comparative perspective. Even if economic geographers have tended to compare regions as opposed to nations, it is a methodological issue close to the heart of the discipline (Clark, Tracey and Lawton Smith 2001). Still, there are issues of considerable difficulty to be assessed and resolved. For the most part, geography and its cognate disciplines have tended to idealise difference. It is commonplace, therefore, to argue that comparative research must acknowledge the integrity and continuity of local tradition (Crouch and Streeck 1997). Many argue that best practice is not easily switched between jurisdictions and within or between institutions (Gertler 2001). So it is tempting to resolve the tensions between the local and the global in favour of the continuity of difference between



market economies. But is this analytical logic sufficient given the enormous pressures for convergence as represented in the epigraph of this paper? We must be more sensitive to arguments that allow for the defection of economic agents from their "home" institutions just as we must be more sensitive to the existence of break points or switching points between whole systems (Bebchuk and Roe 2000).

With respect to the question of European pensions and global finance, I would also argue that any argument in favour of the continuity of difference should be able to deal the following observations about contemporary circumstances. First, any national solution to the demographic crisis will be subject to the increasing power of global finance and the decreasing status and resources of the European nation-state. Second, proposed national solutions are inevitably mediated by other higher (European Union) and lower (regional) tiers of governance, and other tiers or geographical scales of economic processes (Swyngedouw 2000). Third, whatever the historical significance of different systems of finance and corporate governance one particular model, the Anglo-American model of market capitalism, is now in the ascendancy (Aglietta 2000). The idea that the nation-state is an organic whole or, at least, the proper functional entity and scale at which to negotiate the design and structure of pension and retirement income policy, is open to question. With the plasticity of boundaries or borders, individual and corporate defection from the principles of national social solidarity is an ever-increasing reality.

Most importantly, the advent of the Euro may profoundly affect the ability of the nation state to deliver on past promises. As is apparent, the stability and growth pact underpinning monetary union and the introduction of the Euro has narrowed the scope of participating nation states' budget policies (OECD 1999). Furthermore, the vulnerability of the Euro in global financial markets relative to the US dollar and the English pound suggests that it will take some years before markets have confidence in European budget and monetary policies. A number of implications may follow. First, given limited budgetary discretion looming pension obligations will further narrow national expenditure and policy options. Second, past commitments that fall outside immediate priorities (like regional development policy, state aid, and the like) will likely be cast aside. Third, inherited financial institutions and relationships may be scrutinised for their possible contributions to resolving the squeeze on national expenditure options. In this respect, and whatever the advantages of the Anglo-American model, it could be argued that national governments are now preoccupied

with their apparent inability to resolve outstanding commitments for the future (including pensions and many other aspects of life). They appear ever-more reliant upon national, European, and global economic growth for the income (and hence expenditure) to cover existing and increasing obligations (Clark 2000).

The resurgent interest in the analytical principles behind path dependence, agglomeration economies and spatial differentiation my argument may not find favour with the new economic geography. Indeed, it might not find favour with those citizens who wish to protect the accumulated victories of European workers in taming and regulating market capitalism (Boeri et al. 2001). After all, it would seem that those who advocate convergence tend also to have obvious economic and financial interests in overturning historical relationships in favour of market relationships (Deutsche Bank 1996, 1999). Plainly, the international financial services industry has a huge interest in re-forming domestic economic relationships around their competencies. Furthermore, to talk about a "winning model" of global finance is to also talk about a particular model of social life and social welfare. An important aspect of the debate about European pensions has to do with the allocation and reallocation of risk between society (social solidarity) and the individual (market). An economic geography that fails to attend to these issues will be ignored.

### **Demographic Trends and the Demographic Crisis**

Not everyone believes that European demographic trends are or need be a demographic crisis (Boldrin et al. 1999). It could be argued that demographic transformation is an opportunity for economic development and growth; concomitant changing consumption patterns may represent opportunities for product innovation and product development. New markets, new sectors, and new types of customers are plausible consequences of the demographic transition. It is also arguable that demographic ageing need not translate into lower rates of economic growth. Sustained higher rates of technological innovation could profoundly change current cost and benefit calculations made about the possible effects of demographic ageing on labour productivity. Furthermore, it is possible that much higher rates of immigration to Europe could make a substantial difference to the forecast demographic profile of many countries, matching the benefits to the US economy of rapid immigration over the past 20 to 30 years (Ermisch 1995).

Given immigration patterns over the 1990s, I am not convinced that higher rates of immigration to Europe are plausible (Krueger 2000); there are many social and political barriers apparent in countries such as France and Germany that make this a most unlikely scenario. While it is true that the demographic transformation will result in changing consumption patterns and the demand for consumer products, this need not increase substantially the rate of economic growth. Furthermore, it is questionable whether technological innovation could make a big difference to current trends in European labour productivity. To suppose that this is a realistic probability requires assuming European labour markets and capital markets can be as flexible as their UK and US counterparts. Still, whatever my doubts about the plausibility of these related arguments, there remains an important issue to be confronted: how and why demographic trends may be a demographic crisis rather than simply an economic transition to be paid for by higher labour productivity and economic growth.

To explain, let us begin with the basic data. In Table 1.1 known and forecast dependency ratios for major European economies and the US are presented. Comparing country-by-country over the period 1990 to 2030, it is apparent that forecast elderly dependency ratios will likely double or, in some cases, increase by more than 150 per cent. So, for example, the French elderly dependency ratio will double, the German elderly dependency ratio will increase from about 20 per cent to nearly 50 per cent as will the Italian and Swiss dependency ratio. There are some slight variations amongst European economies. Notice, however, that the United Kingdom and the United States will be somewhat less affected by demographic ageing than most European countries. Taking this story further with respect to the total dependency ratio, comparing countries between 1990 and 2030 it is not surprising that these data are viewed with such alarm by leaders of continental Europe. The economic burden of dependency for those working in 2030 will be quite unlike anything experienced by similar cohorts during the 19th and 20th centuries.

At this point in the story, we could go further and compare demographic profiles. Given the fact that these profiles are well-known, and given limitations of space, in this paper I would simply refer the reader to Figure 1.1. In that Figure, the actual and forecast age distribution of the French population (male and female) is given for three dates over the period 1962 to 2020. Two observations can be made which summarise a great deal of post-war French and European history. Obviously the impact of the post war baby boom generation was apparent in the early 1960s,

being the dominant age cohort at each subsequent date. By 2020, the baby boom generation will have transformed conventional expectations of normal pyramid-shaped age distributions -- comparing 1962 with 2020 the proportion and absolute numbers of older people (older than 65 years) will dominate the social and political landscape of France. After the baby boom generation, subsequent generations have been smaller and smaller. There are real prospects of an absolute decline in the French population by the mid-century notwithstanding the contribution made by immigration and the propensity of French people to stay at home in larger numbers than any other developed country.

In summary terms, and in relation to advanced economies, the OECD's (1998) demographic story brings together a set of empirical claims that are also made about contemporary population dynamics by academic analysts, financial service firms, and policy think-tanks (see respectively Disney 2000, Mantel and Bowers 1999, and World Bank 1994). In brief, four related processes appear to drive observed and forecast patterns of European demography through to mid-century:

- The ageing of the baby boom generation
- Longer life expectancy of those aged 65 and over
- Declining age-specific fertility rates, and smaller cohorts of child-bearing women
- Low rates of immigration in the past, and limited immigration rates in the future.

The combined effect of these processes will result in much older populations living through to their late 80s, consuming their own and national retirement savings as well as unprecedented levels of related health care and disability benefits.

By themselves, these trends will represent significant costs to European economies. However, accentuating these trends are overlapping economic policies and expectations that will add additional burdens to the simple demographic effects. Whereas little can be done about demography, the added burdens of current social policy and expectations are the focus of considerable research and political debate (see, for example, Gruber and Wise 1999, OECD 1998). In summary terms, these additional burdens would seem to include at least the following:

- The displacement of older workers through industrial and economic restructuring
- Incentives for early retirement, particularly for those aged 55 and over
- Penalties (reduced benefits and the like) on part-time work by retired persons
- Benefit levels only weakly related to contribution rates.

So, for example, early retirement at high rates of income replacement simply brings forward in time the onset of adverse demographic trends. Put slightly differently, this kind of labour market policy raises sooner than later the required rate of economic growth necessary to accommodate forecast demographic trends.

Population dynamics and economic policy are important aspects of the demographic crisis. But the crucial issue has to do with the financing of retirement and, in particular, the costs of retirement of the baby boom generation through to 2030 and beyond. In Table 1.2 the projected public pension liabilities of major in European economies and the US are summarised and compared. Notice that underlying these projections are complex assumptions made about demography, economic growth, pension benefit values and levels. It is virtually impossible to ascertain, at this point in time, the reliability of such projections. Nevertheless, the gross differences between continental Europe and the Anglo-American world are stark and profound. In many cases, high levels of current public sector expenditure on pensions for European countries may nearly double by the year 2040. By contrast, not only are current Anglo-American public pension expenditures quite small compared to most European economies, these expenditures are predicted to remain small through to 2040. At issue, is the nature of European pension obligations and the methods by which they are to be funded compared to the Anglo-American world (Clark 2001a).

The European demographic crisis is arguably the combination of common population dynamics, overlapping and reinforcing social policies, and the significance and financing of public sector sponsored social security. Even if Anglo-American economies share aspects of the ageing of the baby boom generation, for Europe these demographic trends have become a demographic crisis by virtue of the inherited institutional structure and financing of national welfare states (Ploug and Kvist 1996). In fact, the apparent differences between Europe and the Anglo-American world with respect to the significance of demographic trends are differences driven by basic choices made many years ago about the role and significance of unfunded public sector social security in relation to private funded systems of retirement provision. For Europe, leaving out many subtleties and country specific institutions, it should be observed that:

- Many countries rely heavily upon unfunded PAYG systems of social security, using social solidarity between generations to pay for promised benefits

- In most continental European countries, the public pension goal is to replace a large portion of final worked income rather than provide a basic minimum benefit
- While most countries require individual contributions to social security, such contributions are often actuarially inadequate in relation to the actual benefit
- Embedded within some countries' contribution formula are other important social goals such as income redistribution during and post-employment
- In many countries, public sector pensions have been used as a means of regulating the supply of labour thereby providing younger citizens employment opportunities
- Few continental European countries encourage the private provision of retirement income, although those that do tend to require funded systems as opposed to partially or under-funded systems.

### **Social Solidarity and the Market**

Much has been written about the principles and practice of social solidarity. In this paper, it is not my intention to review the relevant political philosophy or the political institutions underpinning this concept in France and its various expressions throughout continental Europe (see Reynaud 2000). Needless to say, it is familiar to Anglo-American audiences even if it represents a muted echo of past ideals rather than a strong thread underpinning current policies and politics (Esping-Anderson 1989). The idea of social solidarity was important in the UK at the end of the Second World War, witness the preamble to the Beveridge report on social welfare. But it is plain that the discounting of social security benefits coupled with the growth of private funded retirement income arrangements over the last 40 years has effectively neutered the concept. Even so, the search for viable solutions to the demographic crisis in countries such as France, Germany and Italy is informed by an historic commitment to the ideal albeit obvious that it is perceived by many to be an impossible burden on future generations.

The fact that observed demographic trends are a continental European demographic crisis rather than a transition shared amongst all advanced economies has undercut the viability of past commitments and institutions. In fact, in leading think-tanks there is a presumption against PAYG systems of retirement income in favour of the Anglo-American model. Debate about the future of European pension systems often revolves around the tensions between continuity with the past (ideal conceptions of social solidarity and social security) and convergence to some form of

the Anglo-American model (with all that implies about the role and status of markets). At the same time, debate about proposed national "solutions" to the European demographic crisis almost always reference the imperatives driving global economic integration. It is at the intersection between European nation-specific systems of retirement income (built upon principles of social solidarity) and the forces driving the global integration of financial markets (built on principles of market competition) that the European demographic crisis will be resolved.

Who would dispute the reality of these observations or propositions? There are many commentators in France and Germany (for example) who are very uneasy about the role and status attributed to "external" financial markets given what may otherwise be properly thought as a purely "internal" political debate. To illustrate the significance of these issues, consider the following four questions that touch upon the future of European national retirement systems.

*(1) Can solidarity between generations be maintained by increasing the long-term rate of national economic growth thereby avoiding the necessity of discounting the value of retirement benefits and discounting the future welfare of younger generations of workers?* Many analysts believe that the answer to this question is simply no. Considerable analytical effort has been devoted to clarifying the prospects for French social security under a variety of macro-economic scenarios. Assuming benefit formula and entitlements remain unchanged, unpublished simulations by government think-tanks suggest that if social security obligations are to be fulfilled the needed annual real rate of growth would have to be in the order of 3 to 4 per cent through to 2050. While there are circumstances in which such forecasts may be possible, such forecasts are significantly above the long-term post-war trend-line. Indeed, recognising the adverse French macro-economic circumstances through the 1980s and much of the 1990s it would seem difficult to sustain any argument that such annual rates of growth would be plausible year in and year out. A significant recession would increase subsequent needed yearly rates of economic growth; it seems logical that for this scenario to work, higher real rates of economic growth would have to be steady and cumulative in effect (see generally Samuelson 1958 and Aaron 1966).

One way to cope with these macro-economic limits would be to "reform" social security benefit formula and entitlements thereby decreasing the needed annual real rate of economic growth. However, it is apparent that in France attempts at

comprehensive reform have been stymied by political conflict inside and outside of the Chamber of Deputies (Mantel and Thomsen 1999). Nevertheless, incremental reform has gathered momentum through the 1990s involving right-of-centre and left-of-centre governments. For example, moves have been made to increase the number of years ("terms") worked needed for maximum pension benefit. Likewise, benefits to be paid at early retirement have been recalculated to better reflect actuarial circumstances and entitlements. And most importantly, future retirees face the prospect of having increases in retirement benefits linked to the rate of price inflation as opposed to the rate of real wage growth in the economy. In effect, these incremental reforms will make it more difficult for French workers to attain maximum retirement benefits while discounting into the future the real value of those paid benefits as people age through retirement.

*(2) Could reform of European financial systems be the means by which the value and scope of public pension entitlements are maintained and the rate of economic growth sustained at a level consistent with expected standards of living?* In Germany, where commentators have raised the prospect of a tax revolt by younger workers, it has been argued that "reform" would be best placed at the level of capital markets rather than systems of public retirement income (Mantel and Bergheim 2000). This argument has been driven by the remarkable growth of Anglo-American economies over the 1980s and 1990s, and the vital role played by liberal and efficiency-oriented capital market regulatory regimes. It has been argued that a crucial element in any solution to funding public pension entitlements must be in the financial wealth locked-up in existing financial institutions and relationships. We consider this issue in more detail in the next section, noting the connection made by the European Commission between finance, the new economy, and demography. At this point, however, it should be recognised that "reform" of the German financial system could involve the institutions that underpin Deutschland AG. Whereas some Anglo-American commentators argue that these internal relationships have been essential to the success of the German model of stakeholder representation and economic growth, it maybe that these relationships now constrain the performance of European financial markets (compare Dore 2000).

The adoption of Anglo-American financial models and regulatory practices could have far-ranging implications for German corporate governance and existing pension entitlements (Clark et al. 2001). For example, consider the connection



between corporate finance and corporate sponsored supplementary pensions. For many years, large German firms have sponsored supplementary pensions for their workers "funding" those commitments via the much discussed book reserve system. Basically this system of pension funding has subsidised firms' cost of capital; pension funding has been intermingled with corporate treasuries providing the financial resources for new technology, training and investment (Koenig and van der Lende 1999). However, in the Anglo-American world not only are internal financial subsidies at odds with shareholder value, the restructuring of industrial structure and corporate form have been essential tools driving local and global competitiveness. At a time when the federal German government has contemplated introducing tax incentives to encourage firms to provide funded supplementary pensions, financial reform is likely to put in play the future of many German firms while undercutting the viability of book reserve systems of pension financing.

*(3) Could accepted principles of social solidarity be sustained if Anglo-American models of supplementary pensions were introduced in Europe in the near future?* A number of smaller European countries have made significant moves over the past 20 years towards systems of pension and retirement income that combine public sector with private sector contributions. In Switzerland, for example, the federal government introduced in the mid-1980s a mandatory private pension system aimed at sustaining social goals of income replacement and income equality. Likewise, in the Netherlands the government-regulated private system of fully funded supplementary pensions has been required to contribute an increasing proportion of the standard 70 per cent income replacement rule characteristic of the social-security system (Blomsma and Jansweijer 1997). As the costs of public social security have risen, the Dutch government has looked to the private sector to make-up any shortfall in government fiscal capacity. Even so, social solidarity remains the core principle driving the organisation and funding of supplementary pensions. Contribution rates and final retirement income are based, in part, upon a commitment to equality.

Therefore, this question could be answered in the affirmative. But notice any affirmative answer would rely upon mandatory universal participation in highly regulated system of private pension and retirement income. The Dutch model is now widely appreciated in continental Europe, and certainly draws considerable regard from French and German commentators. An important feature of the Dutch model is its comprehensive nature, though firmly embedded in the system of collective

bargaining any defection by individuals and firms is closely regulated by the government (Clark and Bennett 2001). Even in France, it could be argued that their system of unfunded jointly-managed (by the social partners) complementary pensions is similarly worth emulating even if it is weaker on issues like income replacement and income equality. By contrast, Anglo-American supplementary pension systems are characterised by less than universal coverage rates, highly variable contribution rates and pension benefit values, and tax incentives that reward middle-class participants in employer-sponsored pension funds as opposed to lower-paid workers with volatile employment histories (Davis 1995). Social solidarity requires a mode of organisation that can accommodate all kinds of workers according to commonly shared social aspirations.

*(4) Can workers be protected from the risks of the market if some combination of public and private retirement income provision is deemed necessary and inevitable?* For many, the market is the enemy of equitable, stable and predictable retirement income. Indeed, it could be argued that the French, German and Italian retirement income systems being based upon PAYG social security are direct responses to the failure of the funded and under-funded private systems of the inter-war years. By this logic, social solidarity between the generations could be thought to be a means of mutual insurance evening-out long-term fluctuations in economic growth by the transfer of current resources into the past. The problem, however, with inter-generational mutual insurance is that it only works if there is a reasonable balance between payments and entitlements. In this respect, the market may be the only mechanism for balancing up inter-generational accounts. To return to the market as an essential pillar underpinning retirement income is to return a debate that dominated much of the 20th century--the proper allocation of risk between civil institutions, the state, and the market.

In the Anglo-American world, this debate has been resolved in favour of the market. Variable rates of participation combined with variable rates of contributions reflect labour market and capital market imperatives. The maintenance and investment of pension assets relies heavily upon traded securities and assumes, more often than not, a growing stable economic system. Furthermore the apparent shift from defined benefit to defined contribution pension plans, the increasing use of cash balance plans and the re-emergence of individual retirement accounts separate from sponsoring organisations are all aspects of much the same phenomenon: the re-

allocation of risk from institutions to individuals and their families. Given that many Anglo-American social security systems typically provide minimum benefits according to principles of need or welfare rather than social justice, supplementary pensions may be thought to add a necessary but uneven and volatile component to individual's total retirement income. It seems impossible to re-insure such risks; neither markets nor states seem willing to take-up the task (Allen and Gale 1995).

### **European and Global Financial Market Integration**

Having moved from social solidarity to financial markets, we need to better understand the structure and organisation of these markets in relation to European initiatives designed to promote economic development. As I hope to show, proffered solutions to the demographic crisis are increasingly connected to "reform" of European financial markets and the prospects for building a distinctly European new economy. Most importantly, the relatively poor performance of continental European economies over 1990s compared to the US and, to a lesser extent, the UK has prompted national and European policy makers to reconsider the role and status of financial markets. Anglo-American pension fund capitalism provides an important reference point for those driving the process of European financial market integration.

We can treat markets as universal institutions, dominated by commonly understood exchange relations, economic transactions, and competitive advantage and disadvantage. These are the rudiments of any economic theory of market capitalism. We would be short-sighted in underplaying these types of imperatives. But we should also be conscious of the fact that market formation is a deliberate process, just as market agents may pursue various strategies intended to affect and take advantage of the design process. So, for example, the process of European financial market integration has been very much affected by these design considerations--many countries have been reluctant to embrace financial integration without first protecting or enhancing the competitiveness of national champions in relation to potential Anglo-American rivals. At the same time, for many years the economic geography of European finance has been thought properly national by virtue of the difficulty faced by consumers in assessing the integrity and value of financial products offered by vendors located outside of their home jurisdictions (Clark and Bennett 2001).

As we noted above, there is a close connection between national financial systems and corporate governance (Hopt et al. 1999). In Germany, financial markets

have been kept national by overlapping and reinforcing institutions and regulatory practices. Long-term un-traded financial relationships between national banks and local firms, the presumption in favour of corporate insiders as opposed to outsiders, and the internal retention and sharing amongst stakeholders of corporate income have all contributed to a distinctive system of finance. Similarly, the regulation of pension assets and liabilities including quantitative limits on asset allocation as well as strictly enforced year to year asset-liability matching has narrowed the available scope for financial markets and their intermediaries. This general point can also be made, of course, with respect to other continental European countries including France. European financial integration promises to breakdown these preferential relationships and regulations in favour of a single market for financial products and services. Not only may this mean competition between financial institutions whatever their national origins, it may also mean cross-border flows of capital and financial products (De Ryck 1999).

If integration were simply a matter of taking the single market to its logical conclusion, the pace of integration would be slow over the coming decade or so. However, the European Commission has sought to accelerate financial market integration. The introduction of the Euro, the discounting of its value against the US dollar, and the apparent poor economic performance of continental Europe with respect to the US have all given greater urgency to financial integration. Over the past 10 years, continental Europe seems to have missed almost entirely the new economy. To summarise, this can be shown in the following simple ways (Figure 1.2) referencing economic indicators from the OECD's Economic Outlook:

- US real GDP growth accelerated over the 1990s, whereas continental Europe experienced a significant recession in the early 1990s and rates of economic growth at the end of the decade about half that of the US.
- Growth in US employment varied between one per cent per year and three per cent per year whereas continental Europe experienced negative rates of growth in employment over the balance of the 1990s with higher rates of growth by 2000.
- US unemployment declined throughout the 1990s, being less than half the unemployment rate of the major continental European economies by 2000.

Many commentators, Anglo-American and continental European, attribute the remarkable performance of the US economy over 1990s to the emergence of the new

economy. According to optimistic views of the matter, the new economy has brought forth a virtuous cycle of technological innovation, labour productivity, and economic growth. Less optimistically, it is arguable that the new economy prompted a remarkable speculative bubble in US and global financial markets now being unwound through revaluation, liquidation and bankruptcy. Most importantly, the new economy is widely perceived to have introduced very different ways of geographically organising and financing economic innovation (Saxenian 1994). Rather than large multinational firms that either acquire or manage research and development, the driving force behind the new economy has been located with small, often unlisted companies located in distinct regional clusters of innovation like Silicon Valley and Rt. 128/495 Boston--centres of human capital and financial capital. The new economy has been financed by venture capital (from initial stages of start-up to maturation) and ultimately traded securities markets (through initial public offerings).

It is hardly necessary, to recount the logic and dynamics of the new economy. There are now many sources of information on the new economy, including contributions to Clark et al (2000). But it is important to emphasise that many European policy makers have come to believe that the exclusion of continental Europe from this phenomenon is indicative of the following. (1) The shallowness and relative inefficiency of European capital markets, (2) the lack of transparency, knowledge and information of European investment decision-making, and (3) the lack of sufficient risk capital, and (4) the lack of market intermediaries skilled at valuing the costs and benefits of financial risks. The European Commission believes that the new economy is as much a financial phenomenon as it is about the application of internet and electronic technology to production, consumption and distribution. By this analysis continental Europe lacks the necessary financial infrastructure needed to sustain innovation and economic development.

But often ignored in this story of financial risk and technological innovation is the social organisation of the new economy (Teece 2000). Whereas large firms of the old economy manage human resources according to standard rules of functional capacity and authority, firms in the new economy sought to open up hierarchies and devolve line management. As a consequence, standard categories of seniority and responsibility have been overtaken by individual initiative even at the risk of undercutting conventional models of the organisation of work. This is most apparent

where compensation is involved. Many new economy firms have deliberately discounted current income (wages and benefits) in favour of promised future income (stock-options and the like). Shorn of the protection of being employed in large firms, and highly attuned to market fluctuations in their net worth, the promise of the new economy has been immediate reward for individual risk taking. In this world, there is little concern with, or commitment to, social solidarity; the socialisation of risk would seem to be anathema to the motive forces driving the new economy (Thrift 2001).

After almost a decade of debate, the European Commission (2000a) finally produced a viable proposal for a directive covering the investment and management of European retirement systems (11th October, 2000; 507 provisional). This proposal allows for the development of funded private pension systems, matching in substance the flexibility and robustness of Anglo-American regulatory systems. It also provides the means by which European financial integration will both benefit from the growth of private pensions and will contribute to their development as an alternative to national social security. In a speech made just before the launch of this proposal, EC Commissioner Bolkestein (23rd September 2000) noted the pressing need for European financial integration referencing the "knowledge-based and dynamic economy of the next decade". He also noted the vital importance of the forthcoming directive on the supervision of private pension funds. In sum, he managed to connect one with the other intimating that financial integration and pension fund regulation would contribute to the long-term competitiveness of the European single market.

In the Anglo-American world, funded pension plans depend upon the financial services industry for the management and investment of pension assets. Much has been written about the structure and organisation of this industry (see Blake 1995 and Davis 1995). The market for financial services has driven down the costs of asset management, while new products and new investment regimes have expanded the available options open to pension funds and their plan sponsors. For the most part, regulatory regimes are permissive rather than definitive sustaining the autonomy of agents' decision-making according to inherited trust law conceptions of fiduciary duty (Langbein 1995, 1997). It is arguable that this kind of organisational structure has contributed directly to the remarkable performance of Anglo-American financial markets over the 1990s, and the double-digit performance of pension funds throughout much of this time. The European Commission's draft directive sought to emulate this umbrella; considerable attention has been paid to the possibility of

matching up national custodial traditions with the prudent man rule (Brydon 2000; De Ryck 1999).

Social security remains the bedrock underpinning continental European retirement income. But even here proposals have been floated for the advance funding of PAYG social security liabilities (Leinert and Esche 2000). This is particularly apparent in France, where the Charpin (1999) report raised the prospect of establishing a central reserve fund in anticipation of the looming demographic crisis. Advocates of this approach include Bismans and Docquier (1996) and Aglietta (2000). Essentially three arguments may be made on behalf of this idea. Recognising that the long-term real rate of economic growth is about two per cent per annum, the available evidence suggests that the rate of return on invested assets over the past fifty years has been about 10 percent per annum (and about 20 percent per annum over the past seven years (Clark 2000). Therefore the advance funding of liabilities and the investment of social security assets could make a significant cumulative difference to national fiscal capacity compared to the PAYG system (Modigliani et al. 2001). As well, a central reserve fund that was invested according to international best practice may be more cost efficient than the administration of social security (Whitehouse 2000). A central reserve fund could significantly enhance national savings through global equity markets while reducing net costs (Pesando 1996), and may even provide the needed investment in technology, regional clusters and the new economy (Maarek 2000).

While there are some important advocates for such a strategy, there are also many critics who are disturbed about the idea that the funding of social security should be shifted from state guarantees of social solidarity to the vagaries of international financial markets. If one function of social security is to provide a guaranteed core value of retirement income, it is arguable that the state is the proper institution to indemnify that guarantee. However, for Aglietta and others the state now appears to be too weak to sustain such a guarantee. Furthermore the size and influence of global finance promises economic rewards far beyond the capacity of the nation-state and Europe to deliver. Therefore, perhaps the only response left may be to harness the global financial services industry on behalf of the objectives of the social partners. The alternative can only be the discounting of the value of social security and an increase in the rate of defection from social solidarity.

The French debate over the possible advantages of a central reserve fund is, as yet, unresolved. It should be noted, moreover, that there are aspects of the proposal that may fit uneasily with the Anglo-American model of finance which it is presumed to emulate. Most notably, any central reserve fund would remain embedded within the existing relationships between the social partners and the state. Not only would the goals and objectives of such a fund be subject to the national interest, it is likely that the management of investment would also be subject to these relationships. While joint trusteeship is a familiar mode of pension fund management in the Anglo-American world, it is apparent that there are many advantages in separating the interests of plan sponsors from the management of the pension fund itself. This is as true in public sector pension funds as it is also true in private sector pension funds. In the Anglo-American world, the governance and investment performance of pension funds and their service providers relies heavily upon principles such as fiduciary duty. Reasonable doubts may be raised about the investment potential of any fund that was required to satisfy such a multiplicity of constituencies and goals (Clark 2000).

## **Conclusions**

For those that celebrate the achievements of the European welfare state, and for those that celebrate the continuing role that the social partners play in mediating market imperatives, national systems of retirement income are indicative of distinctive and valued traditions of social justice and social protection. Many are wary of proffered "solutions" to the looming demographic crisis; it would seem easier if national systems could be kept intact and adjustment made through macro-economic policy and/or government budgets. Otherwise, there is a sense in which social solidarity may be sacrificed in order to achieve financial objectives which may, or may not, contribute to adequate and secure retirement incomes. This point was made by the EC Commissioner for Employment and Social Affairs in the following manner: "Reforms cannot happen overnight. Pensions must be not only economically sustainable but also socially sustainable" (Diamantopoulou 2000, p. 1). And under the heading "Guiding principles and objectives for pension reforms" the related European Commission (2000b, p. 13) communication noted that "[n]ational choices and priorities... remain the responsibility of Member States."

There are clearly deeply entrenched political interests concerned about the continuing viability of European systems of social security (see Mantel and Bowers



1999). Likewise, amongst academics there are many who suppose that continuity with the past is an essential ingredient in any understanding of the processes of economic development and spatial economic differentiation (Krugman 1991). Notions such as path dependence, lock-in and sunk costs are often invoked to help explain regional and national differences in economic innovation and performance (see Clark et al. 2000). Therefore, on a variety of counts, the idea that European systems of retirement income could or should converge upon the Anglo-American model as suggested by Martin Wolf in The Financial Times goes against the grain of those committed to the integrity of the past. I do not wish to suggest that such commitments are empty gestures of theory or nostalgia. Simply, it is obvious that the past has enormous analytical and political significance in contemporary discussions about the future of European pensions.

If the forthcoming retirement of the baby boom generation was simply a matter of reorganising budget priorities, it is doubtful that so much research and commentary effort would have been expended on the topic of European pensions. As I have tried to show in this paper, European demographic trends are more than evidence of an on-going demographic transition. Demography represents a crisis for Europe for the following reasons. Most obviously, demographic ageing is pronounced in continental Europe (compared to the Anglo-American countries). Furthermore accumulated public policies and circumstances favouring early retirement appear likely to bring forward in time the onset of the financial problems inherent in PAYG social security. And it seems quite unlikely that cumulative long-term rates of real economic growth will be sufficient to cover looming financial obligations. The problem with European demography is that it is simultaneously an issue of ageing, economics, and finance set against the advantages of Anglo-American funded retirement systems and the related structure of global financial markets.

For many European commentators, funding the retirement of the baby boom generation threatens the fiscal capacity of governments and threatens the economic growth potential of Europe's largest economies. In some quarters, these threats also represent long-term threats to the political and social integrity of distinctive national traditions. By this logic, continuity with the past is hardly a recipe for the future: by honouring social solidarity and inherited pension entitlements, the long-term economic integrity of the whole European project must be questioned. On the other hand, it is hard to imagine that continental Europe will suddenly simply overturn past

commitments and institutions by adopting the Anglo-American model. Rather, the most likely scenarios are either *accommodation* with or *incremental convergence* to selected elements of the Anglo-American model. It seems highly likely that forecast social security obligations will be discounted by changing rules relating to maximum benefits and maintenance of the real value of paid pensions. Furthermore, it seems highly likely that France and Germany will in some way or another encourage the private provision of supplementary retirement income and may even institute policies designed to accumulate pension assets (as in the Dutch model).

But notice I have also argued that proffered pension reforms could have significant implications for the financial structure of continental European economies. This is most obvious when considering the intimate connection between German corporate-sponsored supplementary pensions and the German model of long-term un-traded financial relationships and corporate governance. There are many pressures on the German model given the development of international accounting regimes and the performance of Anglo-American financial markets. Pension funding is not the only issue driving the restructuring of German financial, economic, and industrial relationships in relation to global competitors (Berndt 1998a, 1998b). As in so many aspects of the collision between the German model and the Anglo-American model, the problem of funding public and private pension obligations has put in play the costs and benefits of non-market relationships. While German commentators look favourably upon the social market, believing that the proper order is social solidarity and then market imperatives, global finance threatens to re-order this logic such that market imperatives dominate the possible organisation of social relationships.

It is tempting, therefore, to see Anglo-American financial markets as the enemy of continental European society. There is an often-voiced fear of those concerned to protect past commitments and entitlements. Moreover, given the interests of international financial service firms in fostering solutions to the demographic crisis consistent with their competency in global financial markets, political conflict occasioned by attempts at pension reform has seen the fracturing of the post war consensus. Indeed, the rhetoric of reform is deeply affected by a most general conflict between the (Anglo-American) market and (European) society as it is affected by conflicts between local interests (Clark 2001b). In this respect, European pensions and global finance are deeply entwined with domestic and European politics.

However, Anglo-American financial markets may be more than the enemy of social solidarity. The rise of the new economy and the remarkable macro-economic performance of the US and, to a lesser extent, the UK economies over 1990s has brought into question the long-term economic potential of continental Europe. The funding of PAYG social security systems relies heavily upon the real rate of economic growth. Furthermore there is a significant gap between the long-term European rate of economic growth and the long-term real rate of return available in international financial markets. Recognition of these facts of economic life has prompted economic policy makers to reconsider the efficacy of national and European economic policies and institutions. If continental European pension systems are to retain their commitment to social solidarity, corporate and industrial restructuring consistent with the success of the US economy over 1990s may be the future price paid for sheltering European citizens' retirement income from the market.

As I have suggested, it has been widely recognised that the growth of the new economy has been made possible by the existence and growth of large pools of risk capital mediated by the Anglo-American financial services industry. While it may be convenient to discount this phenomenon by reference to the TMT speculative bubble that dominated financial markets during the late 1990s, the underlying real economy has undergone a remarkable transformation affecting technological innovation, labour productivity and real incomes. For a number of European policy makers and commentators, resolution of the looming demographic crisis may be found through the medium of funded pension entitlements. In this respect, we may well see the development of (partially or fully) funded European pension systems designed to take advantage of global financial markets while retaining characteristics consistent with the principles of social solidarity. By this logic, it is probably better to suppose that pension reform will be a form of accommodation with the Anglo-American model rather than significant convergence to its dominant features.

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Table 1.1 Dependency ratios for major European economies and the US (1960-2030)

| Country         | Elderly dependency ratio <sup>1/</sup> |      |      |      |      |      | Total dependency ratio <sup>2/</sup> |      |      |      |      |      |
|-----------------|--|------|------|------|------|------|--------------------------------------|------|------|------|------|------|
|                 | 1960                                   | 1990 | 2000 | 2010 | 2020 | 2030 | 1960                                 | 1990 | 2000 | 2010 | 2020 | 2030 |
| France          | 18.8                                   | 20.8 | 23.6 | 24.6 | 32.3 | 39.1 | 61.3                                 | 51.1 | 52.8 | 51.2 | 59.6 | 67.9 |
| Germany         | 16.0                                   | 21.7 | 23.8 | 30.3 | 35.4 | 49.2 | 47.4                                 | 45.3 | 46.7 | 50.0 | 57.3 | 75.1 |
| Italy           | 13.3                                   | 21.6 | 26.5 | 31.2 | 37.5 | 48.3 | 47.9                                 | 45.5 | 47.8 | 51.5 | 58.8 | 72.7 |
| The Netherlands | 14.7                                   | 19.1 | 20.8 | 24.2 | 33.9 | 45.1 | 63.9                                 | 44.5 | 47.7 | 47.5 | 58.1 | 73.2 |
| Spain           | 12.7                                   | 19.8 | 23.5 | 25.9 | 30.7 | 41.0 | 55.1                                 | 49.3 | 45.3 | 46.9 | 52.7 | 64.8 |
| Sweden          | 17.8                                   | 27.6 | 26.9 | 29.1 | 35.6 | 39.4 | 51.8                                 | 55.3 | 57.9 | 58.5 | 65.1 | 70.4 |
| Switzerland     | 15.5                                   | 22.0 | 23.6 | 29.4 | 37.8 | 48.6 | 51.5                                 | 46.1 | 49.6 | 53.7 | 62.4 | 77.0 |
| United Kingdom  | 17.9                                   | 24.0 | 24.4 | 25.8 | 31.2 | 38.7 | 53.7                                 | 52.9 | 54.0 | 52.3 | 58.3 | 68.0 |
| OECD Europe     | 15.3                                   | 20.6 | 22.1 | 24.7 | 30.8 | 39.2 | 57.9                                 | 50.9 | 50.4 | 50.6 | 57.1 | 67.4 |
| United States   | 15.4                                   | 19.1 | 19.0 | 20.4 | 27.6 | 36.8 | 67.4                                 | 51.7 | 52.0 | 50.5 | 57.4 | 68.0 |

<sup>1/</sup> Population aged 65 and over as a per cent of working age population

<sup>2/</sup> Population aged 0-14 and 65 and over as a per cent of working age population

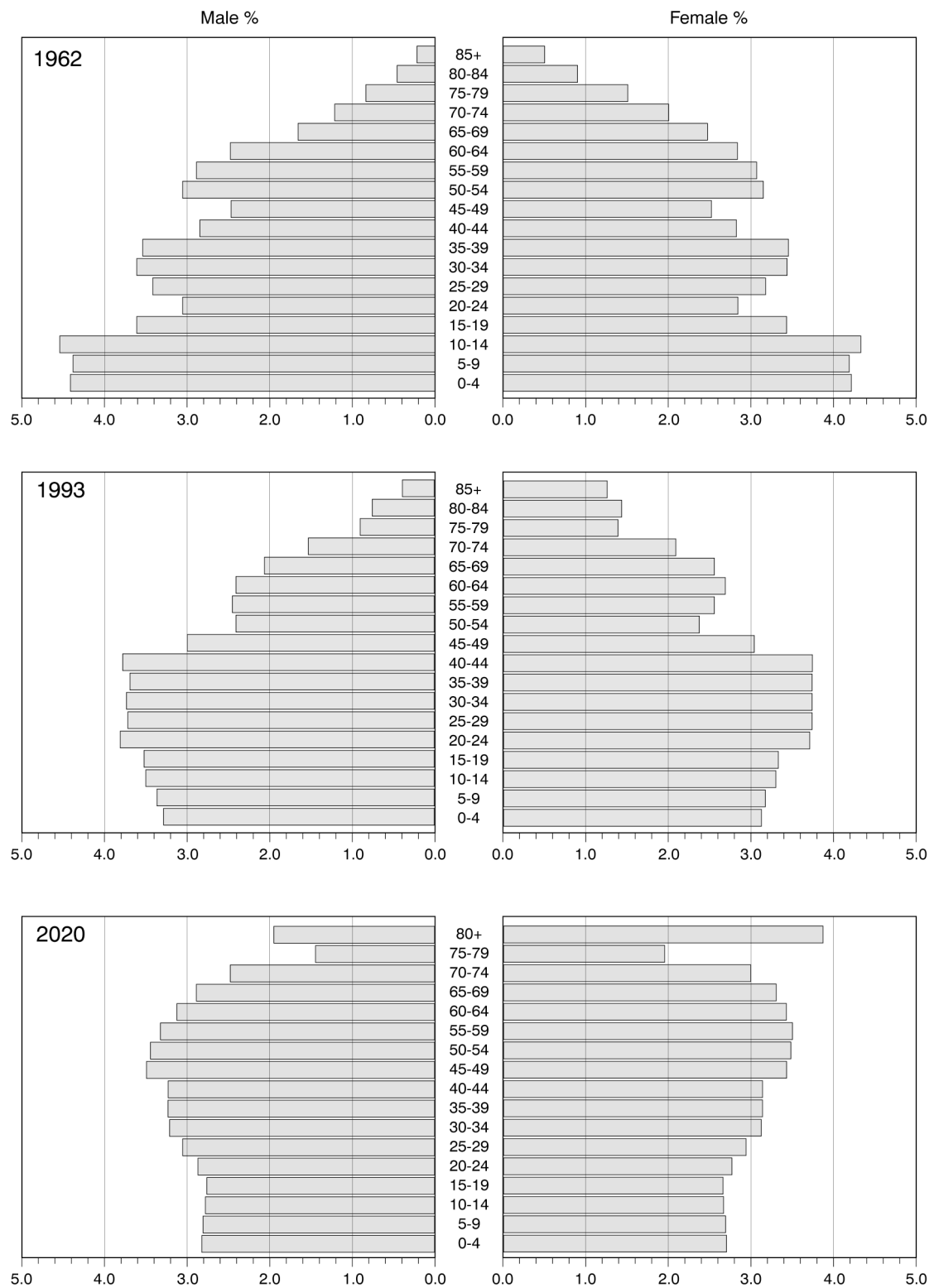
Source: OECD (1997, p. 102) Ageing in OECD Countries: A Critical Policy Challenge

Table 1.2      Net present value of European public pension schemes as a percent of 1994 GDP (until 2070)

|             |       |
|-------------|-------|
| Austria     | -92%  |
| Belgium     | -152% |
| Denmark     | -234% |
| Finland     | -64%  |
| France      | -102% |
| Germany     | -61%  |
| Ireland     | -17%  |
| Italy       | -59%  |
| Netherlands | -53%  |
| Norway      | -124% |
| Portugal    | -109% |
| Spain       | -108% |
| Sweden      | -132% |
| UK          | -23%  |
| US          | -23%  |

Source: OECD (1996) Ageing Populations, Pension Systems and Government Budgets: Simulations for 20 OECD Countries

Figure 1.1 French demographic structure, 1963,1993 and 2020.



Source: United Nations, *Sex and Age Distribution of the World Population: the 1996 Revision*

Figure 1.2 Economic performance of the U.S. and two major European economies, 1990 – 2000 (*OECD Economic Outlook*, December 2000)

