IS THERE A DUTCH WAY TO PENSION REFORM?

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Abstract

In this paper we will try to answer three related questions. First, what explains the lack of (parametric) pension reform in the Netherlands in recent years? Second, in the absence of significant pension reforms, what other avenues have Dutch policy makers pursued with regard to the robustness of the Dutch pension system in the face of ageing? Third, in conclusion, does the overall Dutch policy response really suffice in view of important labour market and demographic changes in the 21st century? While there may be no evident need to recast the design of the Dutch pension system, we do conjecture that Dutch pensions, because of their high aspiration levels, may come under increasing financial strain in the not too distant future.

1. Introduction

Demographic ageing constitutes one of the most pressing policy problems for the advanced welfare states of the European Union. The real challenge lies in how to allocate the *additional* expenditures that inevitably accompany population ageing (Esping-Andersen et al, forthcoming). Demographic pressures are often compounded by design-characteristics in pension systems. The Dutch pension system with its integrated public and private mandatory provision of retirement income is often seen as a benchmark for other Continental welfare states to emulate. Practically all Continental welfare states of Western Europe are based exclusively on public mandatory PAYG systems, financed through wage based social contributions. PAYG financing invokes high non-wage labour costs with serious negative consequences for employment opportunities at the lower end of the earnings scale (Schludi, 2001). Low levels of pre-funding, high dependency ratios, together with low levels of employment of elderly workers, it is argued, put significant pressure on public finances. By contrast, the Dutch pension system, with its integrated public and private mandatory pension provision, it is argued, faces far less fiscal strain as a result of population ageing. It is indeed true that the Dutch pension, combining a general revenue financed, basic pension guarantee with funded extensions of earnings-related (mandatory) occupational pensions, is more effective in terms risk balancing and burden sharing between the generations than traditional PAYG system. In addition, it is also the case that a multi-tiered pension system allows for more flexible adjustment to changing economic and demographic conditions.

Beyond important advantages of a fully-fledged multi-tiered pension system with a strong funded component, we contend that the relative vulnerability or robustness of pension systems to economic and demographic change cannot be judged solely in terms of the balance of the mix of public (PAYG) and private (funded) financing (World Bank, 1994; Haverland, 2001). In addition, levels of maturation of the various tiers, risk exposure of supplementary pensions, and, most important, the overall generosity of the pension system, have to be taken into consideration. In comparative perspective, the Dutch pension system is rather generous. This is related to a number of features: flat-rate first pillar pension benefits are higher than welfare benefits; first pillar benefits are indexed to contract wages not prices; second-pillar benefits are of the DB-type, mostly based on final wage schemes, and also second pillar pensions are in normal times indexed to wages.

In two out of three commonly agreed goals for the open co-ordination of pensions in the EU – adequacy and modernisation – the Dutch pension system scores quite high. The Dutch pension system however is not without weaknesses. We argue below that with respect to the third EU goal of financial sustainability the Dutch system is more vulnerable to the predicament of demographic ageing than is generally assumed on the basis of its seemingly effective mix of PAYG and funded tiers. This is largely due to a conscious political choice not to tamper with the generosity of the Dutch pension. In many other EU-countries, pension reform has been directed towards neutralising the cost of public pensions by lowering future benefits in relation to welfare. Obviously, retaining the relative generosity of Dutch pensions in face of demographic ageing population has a price.

In this paper we will try to answer three related questions. First, what explains the lack of (parametric) pension reform in the Netherlands in recent years? Second, in the absence of significant pension reforms, what other avenues have Dutch policy makers pursued with reagrd to the robustness of the Dutch pension system in the face of ageing? Third, in conclusion, does the overall Dutch policy response really suffice in view of important labour market and demographic changes in the 21st century? While there may be no evident need to recast the design of the Dutch pension system, we do conjectures that Dutch pensions, because of their high aspiration levels, may come under increasing financial strain in the not too distant future.

The paper is structured as follows. In the next section we give a short historical overview of the Dutch pension system, centred on the basic mix of public and private provision of retirement income in the design of the Dutch pension system. Next in section 3, we examine the challenges facing the Dutch pension system: changes in the labour market (more specifically the growth of part-time employment and temporary employment) and the ageing of the population. In section 4 we study the policy responses to these challenges. In particular, we hope to explain why policy makers have shied away from reform endeavours challenging the high ambition levels of public and collective private pension provision. The last section summarises the argument.

2. An overview of the Dutch pension system

The old age pension system rests on three pillars (Bovenberg and Meijdam, 2001; Carey, 2002): the public old age pension, providing compulsory pay-as-you-go pensions; funded occupational pensions; and private provisions. All residents are entitled to a public pension in the first pillar and 92 per cent of employees (including public servants) participate in an occupational pension scheme.

The means test, which was part of the original old age pension decree of 1947, was dropped in the 1956 General Old Age Act (AOW, *Algemene Ouderdom Wet*) because of the implied disincentive for private savings. Accordingly, with the public pension as an effective minimum pension biased upwards in favour of low-wage workers, the elderly do not draw on welfare and thus do not burden social assistance. The AOW pension provides a flat rate benefit from age 65. Entitlement accumulates at a rate of 2 per cent for each year of residence between age 15 and 65. For individuals meeting this requirement in full, the benefit for two persons living together is equal to the net minimum wage (€ 1 145 per month on January 2001) while a pensioner living alone receives 70 per cent of this amount. The statutory minimum wage equals in net terms 55 per cent of the average wage and is adjusted in line with average growth of contractual wages (set by collective agreement) twice every year. However, the Conditional Indexing Adjustment Act (WKA, 1992) allows indexation to be suspended under conditions of a rapid deterioration of the dependency rate, as happened between 1992 and 1995 (Visser and Hemerijck, 1997). Indexation has been fully restored since 1996. AOW pensions are financed through contributions depending on taxable income, with premiums levied as part of the personal income tax.[1]

The second pillar is based on fully funded occupational pensions, managed by employers and unions (see Clark and Bennet 2001 and SER 2000 for details). These plans play a major role, with more than 90 per cent of all employees participating and around 50 per cent of all pensioners receiving an occupational pension. Although there is no statutory obligation for employers to make pension commitments to workers, almost all (98 per cent) do. An important contributory factor is that most workers are covered by sectoral plans, the integrity of which is upheld by mandatory extension of industry-wide agreements between trade unions and employers associations. Admission rules, provisions and benefits are determined in collective bargaining by employers' associations and trade unions. But self-regulation is enveloped within a tight legal framework of supervision. Once pension commitments have been made, they are subject to the Pensions and Savings Act (*Pensioen- en Spaarwet*, PSW), which requires that pensions must be placed outside the company. This rule appears to reflect learning from the 1930s recession when various funds collapsed. Supervision is entrusted to the Insurance Board, which is a private regulatory agency that supervises pension funds and insurance companies. It enforces additional prudential rules concerning funding and valuation of assets.

The usual retirement age in occupational schemes is 65, as for the public pension. Nearly all are of the defined benefit type and three out of four plans, according to a survey of 1999, aim to pay a pension income of 70 per cent of final wage after 40 years of contribution. The other schemes, applying to some 30 per cent of all employees, have lower aspiration levels, using average career wages as target replacement income. Many plans also provide a survivor's benefit. The 70 per cent replacement rate takes into account the public pension through an adjustment technique known as AOW franchise. Occupational pension payments (4.0% of GDP) are almost as large as AOW outlays (4.3%). Both employers and employees pay into the funds, through contributions levied on wages above the franchise. Pension fund assets amount to around 115 per cent of GDP in 2000, with around 40 per cent of those assets invested in equities.

In total, there are about one thousand pension plans. The largest is the funded pension plan for public servants, which has been privatised in 1995. The plan for the health sector is second largest. We observe, in Table 1, that compulsory industry pension funds, although only a small fraction of all funds, account for over 77 per cent of total coverage. The majority of larger firms (e.g., Phillips, Royal Dutch Shell, KLM, Heineken) provide their own funds.

The third pillar of the Dutch pension system is based on private provision, for instance through annuity insurance. Contributions are tax deductible provided that they do not result in a total pension entitlement being built up in 40 years exceeding 70 per cent of final wages at age 65. Given that most supplementary pension schemes aim at an ambition level of 70 per cent of final wages, this in fact leaves little room for the third pillar.

Table 1: Pension funds divided by category

	plans		members	
Company pension funds	847	89.4%	768, 000	15.9%
Compulsory industry pension funds	65	6.9%	3,743, 000	77.3%
Non-compulsory industry pension funds	17	1.8%	286, 000	5.9%
Occupational pension funds	11	1.2%	39,000	0.8%
Company savings funds	6	0.6%	2, 000	0.0%
Pension funds provided by law	1	0.1%	4, 000	0.1%
Total	947	100%	4,842, 000	100%

Source: Insurance Chamber, 'pension monitor', situation as of 1 January 1999.

Summing up, the Dutch system is close to a three-pillar system, with a relatively small third pillar. In the mid-1990s total disposable income for persons aged 65-74 was around 80 per cent of that for people aged 51-64, but this may have fallen somewhat since (Carey, 2002: 37). Table 2 reports the income sources of the elderly. The income share of the basic public pension is about 50 per cent for both single elderly and for (married) couples. Occupational pension schemes provide about 30 per cent, but somewhat less for the older cohorts. Annuities provide less than 10 per cent. If asset income and income from owner-occupied housing is included, however, income from the third pillar amounts to about half the average size (20%) of each of the other two pillars.

Table 2: Composition of retirement income. Percentage.

	public pensions (a)	occupational pensions	asset income (b)	other income (c)
Singles				
65 years and over	49	28	19	4
of which:				
65-69 years	49	28	19	4
70-74 years	48	30	18	4
75-79 years	51	27	18	4
80 years and over	50	26	20	4
couples (d)				
65 years and over	48	29	19	4
of which:				
65-69 years	44	32	16	8
70-74 years	48	29	20	3
75-79 years	49	28	19	4
80 years and over	51	24	20	5

Bovenberg and Meijdam (2001), data from CPB

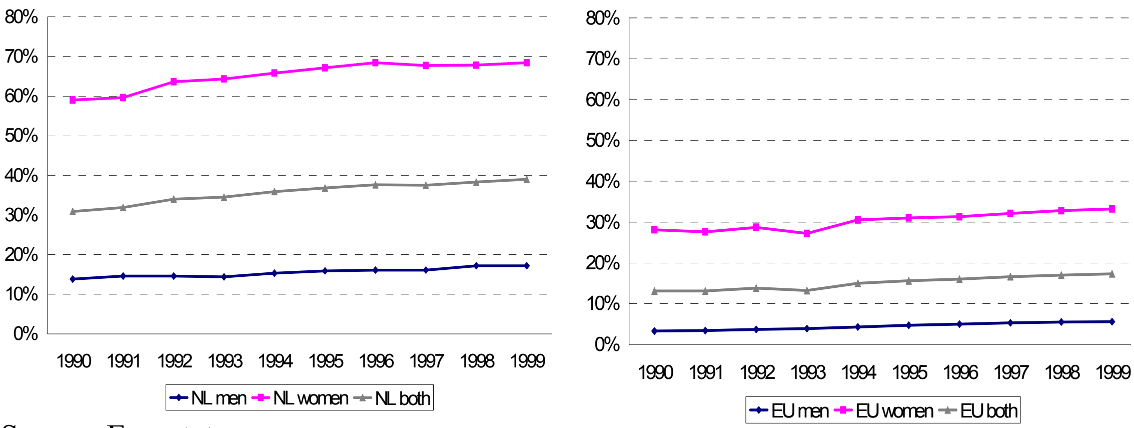
Note:
a) excludes other public transfers
b) includes income from owner-occupied housing
c) includes wages, profits and transfers
d) both partners receive a public pension

3. Challenges facing the Dutch pension system

3.1 Labour market change

The Netherlands is sometimes praised for its 'employment miracle' (Auer 2000; Schmid 1997; Visser and Hemerijck 1997). Between 1983, ending a deep recession, and 2000 the number of jobs increased at a rate of 2 per cent per year, far above the EU average. The expansion of part-time work was a strong contributory factor: three-quarters of the two million new jobs since 1983 were part-time jobs. Most of these jobs went to women and the female participation rate (in persons) jumped from 33 per cent in 1975 to 59 per cent in 1998, the largest rise in the EU (OECD 2000). Strong labour force growth (three times the EU average) explains why, in the 1980s, unemployment, which had reached a post-war record of 13 per cent in 1984, decreased only slowly. In the second half of the 1990s, however, strong job growth translated into a rising employment population rate and a rapid fall in unemployment. The current unemployment rate (early 2001) has dropped to 2.5 per cent, the second-lowest rate in Europe (after Luxembourg).

Figure 1: Part-time employment in the Netherlands and the EU-average (as % of total employment)



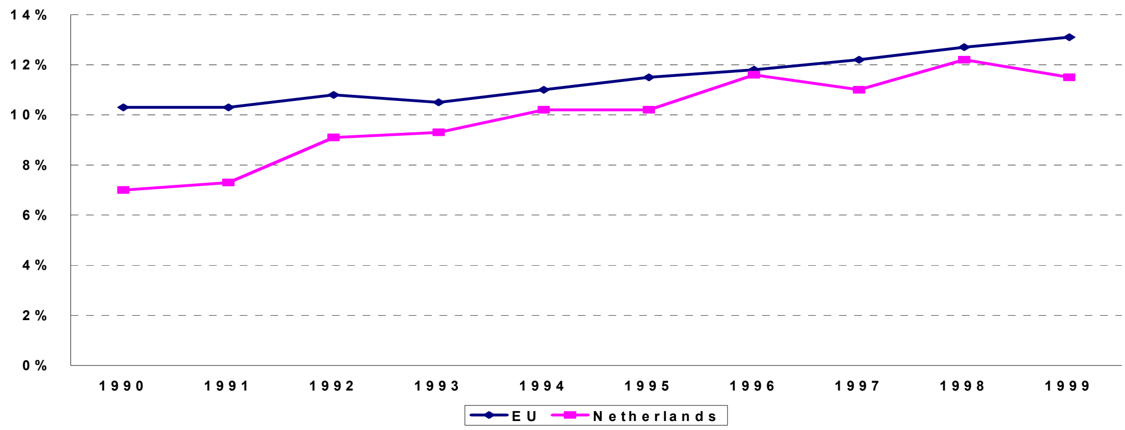
Source: Eurostat.

As can be seen from figure 1, the Netherlands is an outlier in Europe regarding part-time employment (Visser, 2002). The incidence of part-time jobs is 38 per cent in the Netherlands, against 18 per cent in the European Union. During the 1980s the growth of part-time employment accelerated in unison with the rise in female and service employment. The female share in total employment leaped from 25 per cent in 1977 to 39 per cent in 1999 (43% if marginal jobs are included). In 1998 68 per cent of all employed women worked part-time, compared to 45 per cent in 1981. Among men there was a rise from 3 per cent in 1981 to 17 per cent in 1997. Survey data show that Dutch employees more often prefer to work part-time than elsewhere in Europe. This may reflect the fact that the Dutch system is more facilitating towards part-time employment than most other systems in the EU (Visser, 2002).

But as a rule, part-time jobs tend to offer less than full-time jobs in terms of job rights, pay, quality, and careers, and part-time workers accumulate lower pension entitlement than full-time workers (O'Reilly and Fagan 1998). To the extent that part-time jobs become the main form for women's employment, their expansion may contradict EU equal opportunity policy (Rubery et al. 1999). In terms of labour law, employment protection, health insurance and pension rights, part-time work poses a challenge of modernisation (Visser, 2002). In a breadwinner type of welfare state like the Netherlands, the same modernisation challenge is presented by the rising presence of women and in particular mothers of young children in the labour force. Another challenge – both for employment protection law and for social security legislation – is posed by the increased use of flexible contracts, interrupted careers, increased job (and employer) turnover and shorter careers in general. Due to more years of education and the use of pre- and early retirement provisions, fewer workers will have worked forty years.

In 1999 approximately 11.5 per cent of the Dutch employed had a temporary job. The average of the European Union was 13.1 per cent. The share of temporary workers is rising (Figure 2). Since 1992 the quantitative differences between the EU-average and the Netherlands on this issue are small, but a qualitative difference remains. In the Netherlands more than half of people with temporary jobs (6.3% of the 11.5%) did not want a regular job, while in the European Union only 10 per cent of the people who had a temporary job (1.3% of the 13.1%) did so voluntarily (Eurostat).

Figure 2: Temporary employment (as % of total employment)



Source: Eurostat.

These changes in labour market behaviour and composition pose a challenge to the traditional philosophy and organisation of (occupational) pension systems, as having evolved in the industrial age of the 19th and 20th century. Pension coverage of women and people working few hours and provisions for persons with interrupted careers are likely to be inadequate. In addition to employment expansion, as the dominant policy response to the demographic challenge to pension systems – to be discussed in section 4 - there is a need for modernisation of pension systems in response to labour market and social change. We will come back to the Dutch response to that need in section 5.

3.2 Ageing and the Dutch pension system

This section describes how the Dutch pension system is coping with ageing. As noted before, because of both the high rate of coverage of supplementary pensions and their funding, the Dutch pension system is unique among the present euro-zone countries. For this reason, the Dutch pension system is often thought to be less vulnerable to ageing compared to pension systems in the rest of the euro-zone, which are mainly financed by PAYG-schemes. However, as we will argue below, the vulnerability of pension systems not only depends on the specific mix of funded and PAYG-elements, but also on its generosity. This particularly applies to the Dutch pension system: first pillar pensions are above the social minimum, indexed to wages; second-pillar pensions are of the defined-benefit type and most schemes are of the final-wage variant. These features make the Dutch pension system vulnerable to ageing, despite its well-balanced mix between funding and PAYG-elements.

Ageing and its impact on the labour market

Compared to other EU-member states, Dutch population is relatively young: the old-age dependency ratio equals 20 percent, which is four percent below the EU-average (EPC, 2001: 111). Like other countries, a sharp fall in fertility rates since the 1970s, and to a lesser extent, rising life expectancy, will raise the old-age dependency ratio during the first half of this century. However, the expected increase in the old-age dependency ratio between 2000-2050 will be less than the EU average (21 per cent points against 25 per cent points for the EU (15)-average). As a result, the old-age dependency ratio will in 2050 have fallen further below the EU-average. According to Eurostat's baseline scenario, the Dutch labour force will not start to decline until 2016, which is four years later than the EU-average (Eurostat 2001). Projections of the future labour supply assume that the demographic effect will to some extent be compensated by a further increase in female participation rates (OECD 2002:120).

Ageing and its impact on first pillar pensions

The EU's Economic Policy Committee has, in co-operation with the OECD, co-ordinated studies on the impact of ageing on the future costs of first pillar pensions (public expenditure as a percentage of GDP). For these studies a set of commonly agreed demographic and macro-economic assumptions has been used (see for details: EPC 2001). These studies, which were carried out by experts from the Member States, are made for a "current" (or unchanged) policy scenario. Table 3 shows the main results of these studies for the EU15. In order to identify driving forces behind the changes in projected expenditure, the results have been decomposed into four explanatory factors: population ageing, an employment effect, an eligibility effect and a benefit effect.

Table 3 – Decomposition of changes in old age public pension spending 2000-2050 (Level in percent GDP, changes in percentage points)

	Level (% GDP)		Increase 2000-50	Ageing	Employ-ment ratio	Benefit ratio	Eligibility ratio
	2000	2050	(1)	(2)	(3)	(4)	(5)
B	10	13.3	3.3	5.2	-0.9	-2	0.9
DK	10.5	13.3	2.8	4.1	-0.2	-1.7	0.5
D	11.8	16.9	.1	6.2	-0.7	-2.7	2
EL	12.6	24.8	12.2	9.9	-3.6	4	1.4
E	9.4	17.3	7.9	8.2	-2.4	-0.3	2
F	12.1	15.9	3.8	7.7	-0.9	-3.6	0.7
IRL	4.6	9	4.4	4.5	-0.9	-0.7	1.4
I	13.8	14.1	0.3	9.5	-3.1	-4.9	-1.4
NL	7.9	13.6	5.7	5.4	-0.6	0.2	0.5
A	14.5	17	2.5	10.5	-2.2	-2.9	-3
P	9.8	13.2	3.4	6.7	-1.1	0.1	-2.4
FIN	11.3	15.9	4.6	6.6	-0.1	-0.1	-1.3
S	9	10.7	1.7	3.9	-0.5	-2.6	0.8
UK	5.5	4.4	-1.1	2.4	0	-3.4	-0.1
EU15	10.4	13.3	2.9	6.4	-1.1	-2.8	0.6

Source: SER (2002a), based on EPC (2001).

Explanation (1) = (2) + (3) + (4) + (5); the decomposition is based on the following formula:

$$\frac{PPS}{GDP} = \frac{POP\ (55+)}{POP\ (20\text{-}64)} \times \frac{POP\ (20\text{-}64)}{EMPl} \times \frac{BEN}{PROD} \times \frac{PENS}{POP\ (55+)}$$

PPS is public pensions spending (which also coverages disability benefits and unemployment pensions: see for a detailed list EPC, op.cit., p. 16). POP(55+) is the population older than 55, POP(20-64) is the population btween 20 and 64, EMPL is employment. BEN is total spending divided by the number of pensioners. PROD is BBP/EMPL and PENS is the number of pensioners.

The most surprising result of this exercise is that despite the relative modest speed of ageing, first pillar expenditure in the Netherlands will converge from its current relatively low level to the average EU-level. In other words: the projected increase in pension expenditure in the first half of this expenditure will be higher than in most other European countries.

The main factor behind this above average increase of projected public pension expenditure is the benefit-effect. Under current rules, Dutch first pillar pensions are indexed to minimum wages. These are in turn coupled to general wages and therefore to productivity growth. As a result, benefits are assumed to grow in accordance with productivity growth and thus the general standard of living[2]. In contrast, in most other countries benefits are expected to fall behind productivity growth. For example, as can be seen from table 1, in both Italy and the UK benefits are indexed only to prices and as a consequence, will fall far behind productivity growth. This limits the effect of ageing on public pension expenditure in these countries. In addition, Italy assumes a big increase in the employment ratio, which neutralises the effect of ageing on the development of the labour force and through this, the growth of GDP. According to the calculations made by the European Commission, the negative benefit effect of –2.8 in table 3 for the EU15 implies that the average net replacement rate in the EU will fall from its present level of 74 per cent down to 58 percent in 2050 (CEC 2001:197).

Earlier projection of the public pension expenditure (e.g. Drees 1987) in the Netherlands assumed a similar long-run discounting of benefits relative to wage- and productivity growth. This was because total wage growth was supposed to exceed contractual wage growth[3]. As benefits are indexed to contractual wage growth, benefits increases would be smaller than wage increases. Current projections assume that total wage growth equals contractual wage growth and second that benefits are indexed to total wage growth. The Netherlands Bureau for Economic Policy Analysis (CPB), which made the calculations for the Netherlands (see also Van Ewijk et al. 2000) argues that the growth of extra-contractual wage premiums will be limited as relatively more people in the labour force reach the end of their career. Moreover, in view of the increasing number of older voters, the CPB does not considers it realistic to assume that benefits will fall permanently below average living standards (Van Ewijk 2001, pp. 516-117).

In addition to discounting benefits and lowering replacement rates, some countries hope to contain the cost of public pensions by tightening up eligibility criteria. Given the fact that public pensions are based on the residence principle, this policy option is not available in the Netherlands.

Thus, the impact of ageing on public pensions in the Netherlands is neither mitigated through lower benefits or through restricting eligibility. In contrast to most other EU-countries, ageing will almost proportionally affect the increasing cost of public pensions. The question remains of course whether the de-indexation of benefits to general living standards in most other European countries is sustainable as an increasing number of voters will feel the consequences of this[4].

Ageing and its effect on supplementary pensions

The CPB has also made projections concerning supplementary pension contributions as a percentage of wages (Van Ewijk et al. 2000:99-104). According to these projections, contributions for supplementary pensions will slightly increase during coming decades from 6.8 per cent in 2001 to 8.0 per cent in 2060. This rise is the result of increases in life expectancy, which are not matched by later retirement. Again, these calculations were made under the assumption of current policy and rules: the DB-nature of supplementary pensions is retained, and pensions are indexed to wages, which is the common rule in periods in which the financial position is sound.

Given the funded nature of Dutch supplementary pensions, it is hardly surprising that supplementary pension contributions seem to be less vulnerable to demographic developments than public pensions. However, as is well known, funded pension schemes are prone to market- and inflation risks. Because of the so-called leverage effect – defined as the ratio between the present value of accumulated pension rights over the total wage sum (the premium base) – ageing in fact increases the vulnerability of funded pensions to market risks[5]. This especially applies to DB-schemes where, in order to meet a deficit on the balance sheet, surcharges will have to be placed on the contributions of ever fewer active members[6]. The vulnerability of Dutch supplementary pensions to market risks clearly emerges from sensitivity analyses applied to the calculations above. Assuming a 1 per cent lower real rate of return (4.8 % instead of 5.8 %), the CPB concludes that pensions contributions would have to increase drastically[7].

According to the OECD, it is more realistic to assume that the long-term returns for Dutch pension funds will hover around 3.8 per cent instead of the 5.8 per cent assumed by the CPB. This implies that if pension funds do not excercise their right of partial or full indexation suspension, pension fund contributions would need to rise from 6.6 percent in earnings in 2001 to 15 per cent in 2040 (OECD 2002: 131-132). Suspending indexation will be more difficult as pensioners become more numerous and – as is under discussion nowadays – are given seats on pension boards; Dutch pensioners are well organised and most of them view indexation as an acquired right. The majority of participants in Dutch pension schemes have some form of final wage scheme (57% in 2001)[8]. With final wage schemes market risks are shifted to the pension fund[9].

Age-related tax revenues

The picture that emerges from the cursory overview of the impact of ageing on the Dutch pension system presented above is clearly less favourable than is often assumed. The reason for this is that attention has concentrated only on the expenditure side. Increasing retirement income from supplementary pensions, however, will increase tax-revenues. Under current tax policies, pension premiums are tax-deductible, and pensions benefits will be taxed (although because of tax facilities for the elderly at a lower marginal rate than the marginal rate at which premiums are deductible). The CPB estimates the extra direct tax-income as a result of increased pension income to be substantial: 3 per cent points of GDP between 2001 and 2060. In addition, extra revenues out of indirect taxation out of the expenditure of the elderly populations are projected to be 2 per cent of GDP. Together, the age-related tax income is expected to compensate the increased burden of public pensions. Thus, by increasing tax revenues, second pillar pensions will contribute to the financial sustainability of the Dutch pension system. However, the extra tax-income is highly vulnerable to market risks of pension funds. Higher contribution rates to compensate for lower real rates of return would, because of their tax deductibility, mean lower tax revenues.

Dependency on foreign investment income

An increasing source for pension income will be foreign investment. The CPB and other studies assume that the net-foreign asset position of the Netherlands will increase dramatically as ever more pension contributions are invested abroad. As a matter of fact, it is assumed that net income from foreign assets will increase 1 per cent of GDP to more than 10 per cent in 2060[10]. According to these projections, The Netherlands will again be the renters-economy it once was[11]. Income from foreign investment will more than compensate the trade deficits, which reflects the increase of domestic demand relative to production due to population ageing. The downside is of course that the Netherlands will be increasingly dependent on developments in foreign (financial) markets.

Conclusion

The exposition above challenges a number of perceived wisdoms about the vulnerability of pension systems in the face of demographic ageing. First, demographic ageing presents a risk for pensions system; there are no magic formulae. Second, next to the specific mix of PAYG and funding, also the relative generosity of the pensions system should be taken into account for the assessment of its financial sustainability and vulnerability to ageing. Third, the Dutch experiences suggests the emergence of a more difficult trade-off between the generosity and financial sustainability of the pension system in the not too distant future.

4. Policy responses

4.1 Policy responses: general overview

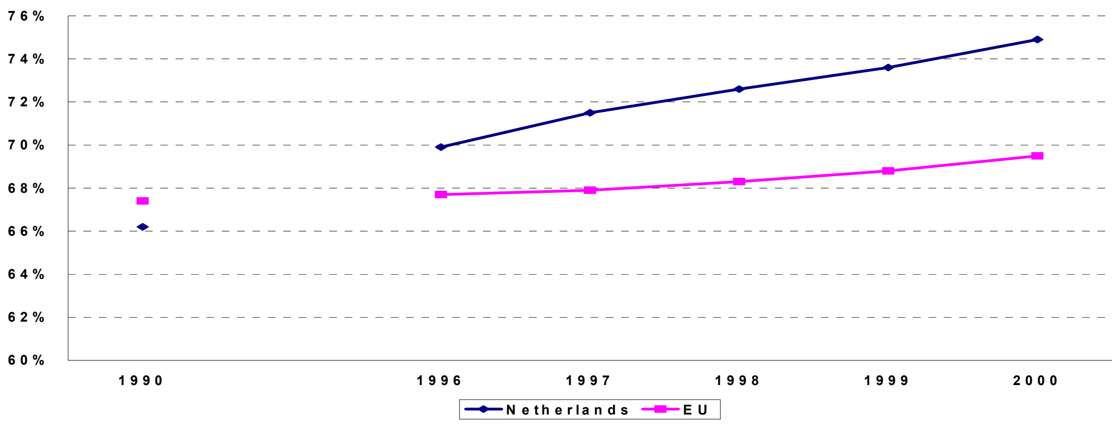
Work, work, work

The dominant policy response to welfare reform (including pensions) in the 1990s was directed towards increasing labour force participation (Visser and Hemerijck, 1997). In the late 1980s, policy makers became aware that the low level of labor market participation was the Achilles' heel of the Dutch welfare state. In 1990 the Netherlands' Scientific Council for Government Policy published a very influential report, advocating a policy of maximizing the rate of labor market participation as the single most important labor market policy goal of any sustainable welfare state (WRR, 1990). In spite of strong job growth and lower unemployment, the Netherlands was at the time still faced with low and declining employment rates of older workers, with rising numbers of disablement pensions and rising costs of social security. The indexation of pensions and benefits to contractual wages, which had been restored in 1989 when the Labour Party re-entered the government after years of opposition, came again under pressure (and was in fact suspended between 1992 and 1995). There was considerable pressure, also from the Christian Democratic coalition partner, to lower the statutory minimum wage and related social benefits. Reducing the volume of benefit claimants, through tightening eligibility criteria and less attractive conditions (for instance in the disability pension system), and increasing the volume of employment became seen as the way forward. In response to the EMS recession of 1992-1993, when job growth stagnated and unemployment was rising again, the government cajoled the social partners into another central agreement on wage moderation. The new policy priority of participation began to make its imprint on all kinds of policy initiatives. Soon, it began to be seen as the alternative to more unpleasant policy alternatives.

In the run-up to the 1994 elections, the Christian-Democrats foolishly suggested that benefit cuts, including old-age benefits, might be unavoidable given the state of public finances (Metze 1995: 216 ff.). The political backlash was devastating: many senior citizens, an important part of their core constituency, abandoned the party and voted for two newly founded 'elderly' parties. The 1994 elections were the election of popular discontent over the issue of welfare reform. The Social Democrats were punished for their role in reducing the level and duration of disablement benefits, breaking an electoral promise in 1989. Though the party also lost a quarter of its seats in the new parliament, due to even larger losses of its Christian Democratic partner, Labour became the largest party and was able to forge a so-called 'purple' coalition with two liberal parties. In its first period (1994-98) that coalition did not slow down in its reform effort, but Labour had a bottom-line condition for its co-operation, drawing its lesson from the 'welfare reform crisis' of the early 1990s: committed to the defence of the level and duration of social benefits, the party was prepared to do everything possible to get the unemployed, young people, women (including single mothers) and older workers back into work. The new government's rallying slogan became 'jobs, job, and more jobs' (Visser and Hemerijck, 1997).

The 'jobs, jobs, and more jobs' approach turned out to be successful as a political compromise between Labour and Liberals. The coalition returned to power in 1998, but slowing down its reform effort and ignoring other issues relevant to quality of life and public services, the purple coalition was defeated in 2002. Economically and in terms of job and income growth, the years since 1994 have been extremely successful (see figure 3). This explains, at least in part, why other policy responses to a possible pensions crisis in the future have had so little appeal. The memory of electoral punishment over the issue in 1994 is still vivid among politicians (the elderly parties have disappeared and the issue was completely absent in the 2002 elections).

Figure 3 Labour force participation rates in persons



Source: Eurostat Labour Force Surveys.

The purple coalition and pension policy

In the wake of the extraordinary elections of 1994, the coalition between social-democrats and liberals explictly committed itself to guarantee public pensions as a basic pension in the future. The goal of government was to enable public pensions to grow in line again with wages. In order to realise this, further policy directed at financing public pension expenditure was announced. These policy options were proposed in a policy memorandum published in 1996[12]. Its main presumption was that indexation of benefits to wages could be preserved. The increase of the public burden could be dealt with by: increasing labour force participation (especially by reducing early retirement schemes); lowering interest rate payments by public debt reduction; and, by broadening financing of AOW. The latter would be achieved by fixing pensions premiums at their 1997 level at 18.25%.

With respect to supplementary pensions, reform efforts have concentrated on the modernisation of the pension system in line with labour market trends, cost-containment, and stronger work incentives in both the public and mandatory supplementary pension in response to demographic and economic change. The government intimated that in the long run individual pension provision should be given a greater role in the total pension package. In order to speed up the desired transition for final wage to average wage schemes, the government threatened to limit tax deductibility to middle wage schemes only. In addition, compulsory membership to sector-wide pension funds should also be limited wage pension schemes. At this point the 'shadow of hierarchy' (Visser and Hemerijck, 1997) of Dutch industrial relations became highly visible. The background to the government's tough policy line was a general concern about the effect of rising pension costs on general wage costs and employment, the effect of rising pension premiums on tax revenues due to tax deductibility rules and the premiums the government itself had to pay for the civil-servant pension fund. In response, anxious to defend their much cherished sovereignty in supplementary pension, the social partners formulated, in the Foundation of Labour, their own proposals for cost containment and the modernisation of supplementary pensions. They strongly opposed any forced changeover from final salary to average wage schemes. However, they did agree to increase coverage of supplementary pensions and to modernise benefit rules in order to increase flexibility and individual choice, as a way to control pension costs in the share of total labour costs (STAR 1997).

This then finally led to a covenant between social partners and government at the end of 1997[13]. In this covenant the government restated its goals concerning the preservation of the public pension as a fully fledged basic pension and the means to achieve this by extending employment. In addition, a public-pension saving fund was set up. The government agreed not to change the fiscal treatment of supplementary pensions nor to change the law on mandatory extension of sector-wide pension funds[14]. In exchange, the social partners agreed to promote the modernisation of supplementary pension schemes (without raising pension costs), cost containment of final wage schemes, an extension of the coverage of supplementary pensions, and the removal of early retirement arrangements. In addition, several recommendations were made to bargainers at sectoral and company level to raise levels of participation of older workers. In short, the government received the commitment of the social partners to modernisation, cost containment in supplementary pensions, and the closing off of early retirement avenues. It had to give in, however, with respect to the changeover to average pay schemes. The social partners in turn successfully defended their much cherished autonomy in the fields of supplementary pensions. This was particularly important to employers. For the trade unions, the pledge to safeguard that basic-income function of public pension was most important.

4.2 Explaining the politics of Dutch pension policy change

While it is not the case that the Dutch pension system is not vulnerable to the pressures of ageing, as we have argued in section 3.2, we do observe a distinct lack of bold pension reform initiatives, especially in the area of public pensions. Hereby, the basic structure of its multi-tiered design remains in tact. Policy adjustments have largely concentrated on preventing the public pension system from burdening central government financing. This has been achieved mainly by broadening the financial base through raising levels of employment. In the second tier, policy changes have focused on containing pension costs as a component of labour costs and increasing work incentives, negotiated by the social partners, by discouraging early exit.

Pension reform offers an example of path-dependent policy change. There are huge hidden costs in whatever system obtains in any country. Politically, pension reform is an especially political risky undertaking as it often challenges what is generally conceived of as ‘acquired rights’. Pension reforms that invoke losses for key groups are very likely to trigger veto powers against social policy reform (Pierson, 1994; Bonoli, 2002). The political feasibility of pension reforms depends to large degree on the institutional capacities of different government’s different political system to orchestrate a reform consensus in the parliamentary arena (often including the opposition) and/or in the corporate arena between the government and the social partners. For the Dutch political system, consociationalism in parliamentary politics and corporatist concertation in industrial relations more or less delineate the institutional capacities of Dutch policy makers (Visser and Hemerijck 1997). By incorporating multiple parties in coalition governments, as a result of proportional representation, and by rendering the social partners a semi-public status in public policy-making, the state can mobilise more resources and rally support for policy change. But divided coalitions and disagreement between the social partners can also inhibit change, precisely because of the need for extensive compromises in both the political and industrial arenas. As a result, Dutch social and economic policy-making is, like all other negotiating policy systems, vulnerable to what Fritz Scharpf has called the "joint-decision trap" (Scharpf, 1997) as a consequence of multiple veto-powers. Especially where the state is weak, disagreement among the social partners may lead to prolonged immobilisation.

The interplay between the politics of accommodation and corporatist concertation goes a long way towards explaining the politics of pension reform (or lack thereof) in the Netherlands in 1990s. Ever since the critical elections of 1994, mainstream political parties have shied away from placing welfare retrenchment (including major policy reform in first pillar pension) on the political agenda. On the basis of the political hangover left by the disability pension crisis, the purple government was in no position to tamper with the level and duration of public pension benefits. Moreover, organisations of pensioners were quite effective at the time in pursuing their narrow single-issue interests in the legislative arena, backed by considerable electoral influence. From this defensive position, the coalition was committed to making the most of "job, jobs and more jobs" policy approach. A broad cross-party political consensus, embraced by the social partners, was constructed around the need for further increases in the employment rate and public debt reduction. By way of broadening the financial base of a generous welfare state by increasing employment and bringing about interest payments through debt-reduction, parametric reforms turned out to be seemingly unnecessary.

Compared to the parliamentary arena, with its relatively weak executive, the corporate arena, with its strongly institutionalised rules of interaction between the social partners and the government, is potentially a less conflictual setting for effective pension reform. That is to say as long as cognitive understandings and normative orientations of actors coincide (Scharpf, 1997). Moreover, political risks are inherently less prevalent in the supplementary tier as earnings-related pensions, negotiated by the social partners, are part and parcel of collective bargaining. The pension convenant is a good example of effective pension policy change. Institutionally, the convenant, struck at the Social and Economic Council (SER) and the Foundation of Labour (Stichting van de Arbeid), provided a forum for the government and the social partners, relatively insulated from electoral considerations, to agree to work out a desired reform strategy. This was, however, achieved under a strong 'shadow of hierarchy'. The government threatened to alter the fiscal treatment of supplementary pensions and to suspend the mandatory extension of sectoral pension funds if the social partners did not agree to agree; this contributed no doubt to successful reform. This prevented the unions from pursuing a more narrowly based strategy of collective action. In order to raise the employment rate of elderly workers, unions agreed for a speedy transition of early retirement schemes to actuarial neutral pre-pension schemes. Central unions and employers federations agreed in the Foundation of Labour to advize negotiators at a lower level to abolish early retirement schemes. The outcome was a compromise in which governments promised not to alter the tax deductibility of pensions premiums, while social partners promised to modernise pensions schemes and to mitigate final wage salaries schemes.

Finally, there is the element of *fortuna*, which in the long run may turn out to be a blessing in disguise. The increased reliance on occupational pensions and as a consequence capital funding under the highly favourable economic, financial, and labour market conditions of the 1990s, reinforced a belief that there was no longer a need for parametric reform or measures of cost containment. With the future maturation of supplementary pension schemes, these schemes will become more prone to capital market risks, which in turn may require significant leaps in contribution rates. At the same time, as a result of adaptive expectations, workers and pensioners have in recent years become used to very high levels of aspirations in periods of exceptionally high levels of return. This surely makes it politically more difficult to venture parametric reforms in the fully indexed, defined-benefit, final-pay pension schemes in the Netherlands (WRR, 1999).

5. Well-prepared to meet the challenges?

Changing labour markets and pension coverage

In view of the rapid growth of part-time and temporary employment, pension coverage has held up remarkably well. The percentage of employees without coverage even declined from 11 percent in 1986 to 4.5 percent in 1996 (SER 2001:138-139). For more recent years no comparable data for the percentage of employees without suppelementary pension coverage are available. However, the percentage of (mostly small) employers whithout a supplementary pension scheme declined from 22 percent in 1996 to 16 percent in 2001 (SER 2002b: 5). It is therefore likely that the percentage of employees without pension coverage continued to decline after 1996.

The rise in pension coverage can be explained by two factors. First, from 1994 it is legally forbidden to exclude part-time workers from supplementary pension schemes. Second, as has been noted before, social partners committed themselves in the pension covenant to raise pension coverage in general. This susbsequently led to an agreement to increase pension coverage in the termporary work sector. Moreover, it has resulted in a lowering of age requirements for participation in supplementary pension schemes.

Debt reduction and the financial sustainability of public pensions

One way to examine whether the challenge of ageing can be met is by looking at the sustainability of public finances. The CPB has calculated, given their projections of public pension spending under current arrangements (see section 3), a time path for a sustainable development of public debt. This time-path has been derived under the assumption of efficiency (tax smoothing) and equity (no externalisation of ageing cost to coming generations)[15]. In addition to the costs of public pensions, the effect of ageing on public health costs has been taken into account. Further, the increase of tax revenues from the spending from pensioners has been considered. The resulting time path of public debt implies that debt should be redeemed within 25 years. The fall in future interest rate payments will be sufficient to compensate for rising costs of ageing without raising tax- and contribution rates. To achieve this, the so-called EMU surplus should be improved permanently by 0.7 percent in 2001. For the two first decades of this century this implies on average a government surplus above 1.5 percent. This requires a high level of fiscal discipline by coming governments. Postponing the necessary adjustment to make public finances sustainable increases the required improvement of the budget balance.

Dutch public finances are not yet on a sustainable path. As a matter of fact, public finances have deteriorated sharply because of the recent growth-slowdown. For 2003 a deficit is even expected. Given the strong pressures to increase spending on education and health, and taking into account given the required adjustment, it is doubtful whether a new government will bring public finances on a sustainable path by targeting a budget surplus over 1.5 percent GDP annually. This will mean that it will become harder and harder for future governments to bring public finances on the sustainable path, as calculated by the CPB.

As has been noticed in section 4.1, a public pension saving fund was set up in 1998. The purpose of this fund is to earmark part of the debt reduction and savings on interest payments for financing the future rise of public pension expenditure. However, since essentially the fund only brings about a rearrangement of government assets and liabilities, no actual pre-funding takes place (Van Ewijk et al 2000:58). In fact, by setting up the fund, only future expenditure for public pensions is earmarked. Politically it was used to silence concerns by elderly parties over the credibility of the governments promise not to meddle with pension benefits or the legal retirement age.

Raising participation rates

The least painful way to achieve public debt redemption would be a rapid broadening of the tax base by increasing employment. Employment rates in the Netherlands still leave plenty of scope for further improvement: participation rates of elderly (female) workers are still low and the female participation rate is – despite its hike over the last decade – still below the rates achieved in Scandinavia or the US. However, the projections of public pensions costs discussed in section 3.2, already take this into account: female participation rates are assumed to rise in coming decades by 9 percent points. This means that considerable efforts will have to be made for any additional increases in participation rates.

While there is ample scope for further increases in labour force participation, pushing the employed population up to over 75 per cent (as in Scandinavia or the United States), as we have intimated above, may require policies for which political support may be lacking. There appears to be much hesitation to promote longer hours and more participation among (single) mothers and married women. Given the preference for part-time work, as expressed in surveys, longer hours may indeed find little support. Another difficult issue is how to increase the currently very low employment rate of ethnic immigrants, particularly older men and women, many with little education or language skills.

The activation of older workers, both native and immigrants, is another timely predicament. Replacing early retirement schemes by actuarially neutral pre-funded pre-pension arrangements has been a very important step in raising the employment rate of older workers. However, other exit routes like disability insurance and unemployment insurance should be closed as well.

Dutch policy makers now advocate 'active ageing' as an alternative to early retirement. The idea is to keep older people in the work force by measures that make it possible to combine work and retirement. This calls for further reforms. In general, work-organisation and human resource policy needs to be more focussed on an ageing work-force and the labour market position of older workers needs to be strenghtened. There has been progress in this field, but clearly more has to be done to ensure that people will remain longer in the work-force and are willing to maintain their human capital (see also: Bovenberg 2001; OECD 2002: 139-141; Remery et al 2001).

Reducing the vulnerability of supplementary pensions to ageing

It was agreed in the pension covenant of 1997 that in order to contain pension costs with an eye to the ageing population, backservice loading in final wage schemes should be contained. This was done by limiting the amount by which above average individual salary increases would be taken into account and by limiting the impact of wage increases just before retirement. In addition, indexing of accrued rights in average wage schemes and of pension benefits should become to a greater extent conditional on financial results of the pension fund. The review of the pension covenant in 2001 claims that on both issues the pension covenant has been successful (see STAR 2001).

It can be questioned to what extent the further abolishing of pure final wage salary schemes and unconditional indexation has been helpful in reducing the vulnerability of supplementary pension funds to market risks[16]. It should first be noted that the relevant percentages of pure final wage schemes and schemes with unconditional indexation of benefits were already low to begin with. More importantly, one may doubt whether these measures will be sufficient. Almost all supplementary pension schemes remain of the DB-type and, despite the growing importance of average wage schemes, a majority of participants still fall under some variant of final wage schemes. The latter are, because they shift market risks to the pension fund, most vulnerable to ageing.

It has been noted in section 3.2 that increasing supplementary pension contributions will affect tax revenues. This is because the marginal tax rate at which pension premiums are deductable is lower than the marginal rate at which pension income is taxed. In this way the vulnerability of supplementary pensions to ageing and the sustainability of public finances in view of ageing are linked.

Conclusion

Our answer to the question of whether the Dutch pension system is well-prepared to meet the challenges of changing labour markets and population ageing is mixed. To be sure, we consider it remarkable that coverage of supplementary pensions has increased over time despite the increasing number of people working part-time or in temporary jobs. We also consider it important that incentives to early retirement have been phased-out. This constrasts for example with the situation in neighbouring Belgium or nearby France, where any discussion on reversing the pathway of early retirement has been blocked (Ebbinghaus 2000).

Maintaining the high level of generosity in Dutch pensions in the perspective of an ageing population clearly has its price and asks for timely measures. Maybe the Dutch population is willing to pay this price. However, it is also possible that an increasing burden of the Dutch pension system puts the inter- and intra-generational solidarity, which is at the heart of the Dutch pension system, under pressure. This is certainly the case if it is reinforced by societal trends such as increasing labour mobility and heterogeneous preferences of individuals which might limit the potential for risk-sharing in pension systems (see also de Laat et al. 2000). In this situation it might become necessary to reduce the generosity of the Dutch pension system and limit implicit inter-generational transfers within the second pillar. This can be done by gradually increasing the statutory and pivotal retirement age or by gradually reducing the ambition level of the pension system (see Diamond, 2001: 1-12; OECD 2002: 142-143; Bovenberg 2001). In addition, a more rapid change over to conditionally indexed average wage schemes could be realised[17]. Furthermore, actuarially fair and demographically neutral financing methods for supplementary pension schemes should be applied. As a consequence, individuals who want to retire earlier, or who reach for a higher than average ambition level, should rely more on individual pension provision. In this way, future boundaries between public and private pension provision would gradually shift toward more third pillar pension provision.

6. Bibliography

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Notes:

[1] In 2000 the contribution rate was 17.95 per cent of taxable earnings (except for earnings in the lowest income bracket) up to € 27 009, only payable by employees and the self-employed.

[2] Actually, indexation rules are more complex and the degree of wage indexation varied over time. On average over the period 1961-1993 there has almost been full indexation (Vording and Goudswaard 1997: 37-41). However, especially during the 1980s public pension benefits have lagged behind wage growth (see also Bovenberg en Meijdam 2001:44-45). Because supplementary pensions filled up the gap left by the public pension system to ensure that the ambition level of the pension system could be retained, boundaries between public and private pension provision have shifted to some degree over recent decades.

[3] It was projected extra-contractual wage increases would be 1 percent per year. As public pension benefits are indexed only to contractual wage developments, public pensions would over the long-term stay behind general welfare developments. As a result, according to Petersen (1988) in discounted terms benefits would fall by more than 40%.

[4] See also Van Ewijk 2001: 514-515, who calculates that with indexation to real wage growth, the burden of Italian public pensions would rise with 12 percent poits of GDP.

[5] See for a formal exposition of the relation between the leverage ratio and the vulnerability to unforseen shocks: Van Ewijk et al., op.cit., pp.108-111. The civil-servant pension fund (ABP) expects the leverage ratio to increase from 6 to 9 over the coming thirty years (Ponds et al. 1999:100).

[6] See Van Ewijk et al., op.cit. pp. 103-104. It is implicitly assumed in the text that general population ageing is reflected in the ageing of the members of the pension fund.

[7] Van Ewijk et al. op.cit., p. 68. See also: Bettendorf, Bovenberg en Broer (2000). These authors examine the consequences of a possible fall of the real rate return as a consequense of ageing in OECD-coountries on Dutch supplementary pension funds.

[8] The figure on final wage schemes is from Pensioenmonitor 2001, p. 7. Almost all of the final wage schemes include provisions that discourage strategic wage setting just before retirement. These wage schemes are therefore reffered to as 'mitigated' final wage schemes.

[9] See Jansweijer (1999) for a comparison between final wage schemes, average wage schemes and defined contricution schemes regarding the coverage of various risks.

[10] Van Ewijk et al. op.cit., p. 63; Bettendorf et al. p. 68.

[11] During the high-days of the Dutch renters- economy – at the end of the 18[e] century – investment income (government bonds) amounted to 12% of GDP. Half of this came from abroad (Van Zanden en Van Riel 2000, p. 36).

[12] Werken aan zekerheid, Tweede Kamer, vergaderjaar 1996-1997, 25 010, nrs. 1-2.

[13] Convenant inzake arbeidspensioenen, Overeengekomen tussen het Kabinet en de Stichting van de Arbeid op 9 december 1997, Stichting van de Arbeid, publicatie 12/97.

[14] However, fiscal treatment of early retirement schemes have recently been changed. The tax deductibility of Early retirement schemes has been phased-out by 2022. In the future only those schemes will be eligible for tax deductibility which provide actuarially neutral adjustments to pensions for early or late retirement.

[15] See for details :Van Ewijk et al, 2000 pp. 31 ff.; Van Ewijk, 2001, pp. 517-518. The timepath for a sustainable public debt has been confirmed by other Dutch studies (e.g. WRR 1999).

[16] See also WRR, 1999:201-202.

[17] This does not necessary mean a decline of the average generosity of the pensionfund: see WRR, 1999: 206.