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THE TAXATION OF OCCUPATIONAL PENSIONS

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Summary

The Commission has recently published a Communication on tax obstacles to the cross-border provision of occupational pensions. This Briefing outlines the widely different provisions for such pensions in the Member States, and the basis for their taxation. It then outlines the problems dealt with in the Commission document, and the solutions proposed. An Annex places the subject in the wider context of demographic trends and the reform of pensions systems in general.

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1. Introduction

Pension schemes in the European Union are generally classified under three headings:

- **"First pillar"** schemes organised statutorily within the public sector, largely on a "Pay-As-You-Go" (PAYG) basis: i.e. current pensions are paid out of current contributions.
- **"Second pillar"** or occupational schemes, generally resulting from collective agreements between employers and employees, and on the basis either of invested pension funds, or of company book-reserves.
- **"Third pillar"** schemes, mostly individual pension plans organised by commercial financial service providers on the basis of invested funds.

Both the second and third pillars can be described as "supplementary" schemes, although the term is also used to refer only to the second pillar[1].

In June 1997 the Commission published a "Green" consultation paper on "*Supplementary Pensions in the Single Market*". This drew attention to a number of specific problems affecting the development of such schemes within the EU as a whole, and especially across national frontiers. In particular, Chapter V covered "*The Importance of Taxation for Supplementary Pensions*". It noted that

> *"the tax rules which have been developed over many years are extremely complex and specific to each Member State",*

and created obstacles both to the free movement of workers and to a single market in financial services. Reporting on the results of the consultation[2], the Commission observed that

> *"these tax distortions are regarded by the industry and by the financial sector as the main obstacles to the establishment of a genuine single market in supplementary pensions."*

In November 2000 the Commission published a draft Directive on "*the activities of institutions for occupational retirement provisions*"[3], dealing largely with the management of "institutions for occupational retirement provision" (IORPs). The text made no reference to taxation issues, however, which the Commission promised to address in a further document.

"The elimination of tax obstacles to the cross-border provision of occupational pensions"[4] duly appeared in April 2001, but taking the form of a Communication rather than draft legislation.

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[1] A legal definition of supplementary pension schemes is given in Article 3(b) of Directive 98/49/EC of 29 June 1998 on "Safeguarding the Supplementary Pension Rights of Employed and Self-Employed Persons Moving Within the Community":

> *"'supplementary pension scheme' means any occupational pension scheme established in conformity with national legislation and practice such as a group insurance contract or pay-as-you-go scheme agreed by one or more branches or sectors, funded scheme or pension promise backed by book reserves, or any collective or other comparable arrangement intended to provide a supplementary pension for employed or self employed persons;"*

[2] COM(1999)134 of 11.5.1999

[3] COM(2000)260.

[4] COM(2001)214

2. Supplementary Pensions

The Commission estimates that about a quarter of the EU's working population is currently covered by some form of occupational pension scheme. It also notes, however, that the percentage varies widely between Member States, from only about 5% in Italy to over 80% in France, the Netherlands and the UK (see Table 1). In terms of pension payments, moreover, occupational schemes account for only around 7% of the total,[5] varying between 2% in Italy to 28% in the UK and 32% in the Netherlands.

There are, broadly, two different types of occupational pension scheme:

- **Defined-benefit** or salary-related schemes, where the pension is related to the number of years during which contributions have been paid, and to final or lifetime earnings.
- **Defined-contribution** schemes, where employer and employee contributions are invested, and the accumulated capital sum is used to buy an annuity on retirement. The level of pension is therefore related to the performance of the fund.

The extent to which schemes are fully funded, however, varies widely. The highest degrees of funding are again to be found in the Netherlands and the UK, where pension fund assets as a percentage of GDP are not far below 100%. This compares with percentages of 2% or less in Spain and Italy, and under 4% in France (despite the high level of coverage).

There are other significant variations between supplementary pension schemes: for example, whether employers are obliged to provide schemes; whether membership is mandatory; the age at which pensions become payable; the relationship of payments to salary levels; whether risks other than old age are covered by schemes; etc.

3. Taxation: the systems

The Commission distinguishes three levels at which occupational pensions can be taxed: the contributions; the investment returns; and the pension payments themselves.

3.1. The contributions.

The main issue in the case of payments into occupational pension schemes is whether these are paid out of pre- or post-tax income: i.e. whether they are exempt from normal income tax. In all Member States there is some exemption; but, as the Commission notes, there are variations between Member States as regards:

- the amount of exemption permissible; and
- the definition of schemes into which payments from tax-exempt income can be made.

It is also perhaps useful to make a distinction between employee contributions and those made by employers. In the case of **employee contributions**, exemption means that payments into a pension fund can be deducted from the employee's total income before assessment for tax. The effect can therefore vary depending upon the employee's marginal tax rate.

[5] The "Green" paper of 1997 quoted figures for 1994 (which excluded Austria, Finland and Sweden) of 88.8% for Pillar 1, 7% for Pillar 2, 0.9% for Pillar 3, and 3.3% for other schemes (e.g. means tested payments).

Table 1: Occupational Pension Arrangements ("pillar 2") in EU Member States

Country	Pensionable age	Provision of schemes compulsory ?	Membership of schemes compulsory?	Method of Financing	Entitlements	Account taken of state pension	Est. Coverage (% of total private employment)	As % of total pensions
Austria	65(m), 60(w)	No	No	Funded/book-reserved		No		
Belgium	65(m), 60(w)	No	No	Funded/PAYG	60% final salary	Yes	31	8
Denmark	65-67	No	Yes*	Funded	60-70% final salary	No	80	18
Finland	65 + early ret.	Yes	Yes	Funded/PAYG	60-66% final salary	Yes		
France	65 + early ret.	No	Mostly Yes	Compulsory funded Voluntary PAYG	80% final salary	No	90	21
Germany	65 + early ret.	No	Private sector No Public sector Yes	44% funded, 56% book-reserved	Variable	No	46	11
Greece		No	No	Limited funding			5	
Ireland			Private sector No Public sector Yes	Funded.			40	18
Italy		No	No	Partial funding			5	2
Luxembourg		No	No	Mainly book-reserved			30	
Netherlands	65 + early ret.	No	No (Yes for groups)	Funded	70% of final or average salary	Yes	85	32
Spain	65	No	No	Funded (book-reserve prohibited)		No	15	3
Portugal		No	No	Funded			15	
Sweden		No	No	Funded/some book-reserved				
UK	65(m), 60(w) + early ret.	If more than 4 employees	No	Funded	66% final salary	No	48	28

Sources: "Pension Systems in the European Union" (Kluwer Law International, 1999). Progress Report EPC/ECFIN/581/00 (Economic Policy Committee, 6.11.2000). Supplementary Pensions in the Single Market (Commission Green Paper, 1997).

* Mandatory for individual, but contributions negotiated between employee and employer

In the case of **employer contributions**, the issue is whether or not they are to be considered part of the employee's taxable income. In most Member States they are not, and are considered instead a corporate expense or a liability on the balance sheet.

3.2. The Investment Returns

Where supplementary pension schemes are organised on the basis of a fund invested in assets, the issue arises as to whether tax should be levied on:

- the income from the assets; and
- any appreciation in the capital value of the fund.

The Commission paper notes that some tax is levied in at least three Member States: Denmark, Italy and Sweden.

One consideration in this context may be to how far pensioners themselves benefit from any especially good performance by a particular pension fund. In many Pillar 3 Schemes, pensioners will receive higher pensions the better the fund performs (and lower pensions if it performs especially badly); and in most Member States these payments will be fully taxed. Where pension levels are defined in relation to final or lifetime salary, however, the benefits of good fund performance may, in the end, accrue only to the employer.

3.3. The payment of pensions

The Commission notes that most Member States tax pension benefits; but that the rates of tax and of tax-free allowances vary considerably. It also notes the distinction made, in some cases, between:

- regular payments made as income; and
- lump sum payments.

The latter are sometimes un-taxed or taxed at a lower level; and sometimes banned entirely. The general tax regimes applying to pensions in EU Member States are outlined below.

Table 2: The taxation of pensions in EU Member States

Austria	Taxed as personal income.
Belgium	Normal taxation regime with some deductions (80% limit)
Denmark	Taxed as personal income.
Finland	Taxed as wage income. Small pensions entitled to special deductions.
France	All pensions included in household taxable income.
Germany	Only partly included in personal income tax base and taxed as "other income".
Greece	Taxed as personal labour income.
Ireland	Subject to income tax.
Italy	Taxed as wage income, but untaxed below a certain threshold.
Luxembourg	Partly treated as wages.
Netherlands	Taxed as labour income. Returns from pension funds exempt.
Portugal	Taxed as wage income above a threshold.
Spain	Taxed as labour income.
Sweden	Taxed as wage income.
UK	Subject to income tax.

Source: "The Future Evolution of Social Protection from a Long-term Point of View: Safe and Sustainable Pensions (COM(2000)622).

3.4. Types of system

The Commission paper classifies the systems of taxing pensions into three types:

1. **Taxed, Exempt, Exempt (TEE),** where contributions must paid out of taxed income, but neither investment returns nor benefits are in principle subject to tax. Only Germany and Luxembourg fall into this category.
2. **Exempt, Taxed, Taxed (ETT),** where contributions can be paid out of untaxed income, but where both investment returns and benefits are subject to tax. Denmark, Italy and Sweden fall into this category.
3. **Exempt, Exempt, Taxed (EET),** where neither contributions nor investment returns are subject to tax, but where benefits are. All other Member States fall into this category.

Inevitably, this classification is a simplification of a much more complex situation. It does, however, highlight the important distinction between those Member States where contributions are paid out of taxed income, but benefits are in principle untaxed (Germany and Luxembourg); and those Member States where the reverse is true (all the rest).

4. Taxation: Problems and Answers

These differing taxation system raise a number of problems for the provision of occupational pensions; for example:

- How can double taxation or non-taxation be avoided when employees move between ETT/EET and TEE countries on retirement?
- When a company has employees in more than one Member State, should it be possible to set up a single pension fund for all, or must there be separate funds for each country?
- Should contributions paid into a pension scheme in *another* Member State qualify for tax relief on the same basis as those into a domestic scheme?
- When an employee moves to a job in another Member State, should it be possible to transfer the accrued pension capital from a fund in the first country to one in the second?
- Alternatively, when an employee moves jobs in this way, should it be possible to remain in a scheme in the first country ? If so, on what tax basis?
- When benefits are paid from a fund in one Member State to a pensioner in another, how can it be ensured, without the application of excessive restrictions, that the tax due in the second country is actually collected?

In part such problems are inherent in the differences between systems: for example, varying criteria for recognising a "tax-approved" scheme. However, they are also due in part to the way in which Member States interpret and apply their own domestic tax legislation: for example, a reluctance to allow residents to participate in foreign pension schemes for fear that tax will be evaded.

4.1. The ETT/EET/TEE problem

The Commission paper draws attention to the fact that, under provisions of the OECD Model Tax Convention[6], a pensioner is normally taxable in the country of actual residence. This applies even if contributions to the relevant pension fund have been made in another country; and irrespective of whether they have been paid out of taxed or untaxed income.

[6] This Convention has no legal force, but most bi-lateral tax treaties follow it closely.

This situation has a number of consequences (see Table 3).

- Where contributions have been made out of untaxed income, but the pension is paid in country where no tax is levied on benefits (EET/ETT ►TEE), tax may be avoided altogether.
- Where contributions have been made out of taxed income, and the pension is paid in a country where benefits are taxed (TEE ►EET/ETT), the result can be double taxation.
- Where contributions are made out of untaxed income, and the pension is paid in a country where tax *is* levied (EET/ETT ► EET/ETT), there will be a transfer of fiscal capital from the country of employment to the country of retirement.
- In contrast, where contributions are taxed, and the pension is paid in a country where no tax is levied (TEE ►TEE), there will be no such fiscal transfer.

Table 3: Effects of transfers between systems

	To EET	**To TEE**
From EET	Fiscal transfers	Tax avoidance
From TEE	Double tax	No fiscal transfers

The Commission's preferred solution is to "*strive for alignment of Member States' pension taxation systems on the basis of the EET principle*" – in effect, a switch of systems by Germany and Luxembourg. It does not, however, propose legislation.

The **main logic behind the EET system** is that occupational pensions are, in effect, deferred income, which should be taxed at the time the income becomes available. Tax relief on contributions encourages saving for old age, which – though it involves an immediate loss of revenue in the short term – will help reduce the fiscal burden of public provision in the future. Finally, the Commission observes that

> "*it helps to cope with demographic ageing as it reduces tax revenues today in exchange for higher taxes when the demographic dependency ratio will be much more unfavourable*"[7].

As against this, **the logic behind TEE** is that occupational pension funds – especially when benefits can be paid as a lump sum – are a form of investment like any other, and should not enjoy a privileged tax status. Deferral of tax until benefits are drawn, moreover, involves a revenue loss, since the marginal tax rates of pensioners are usually lower than for

[7] COM(2001)214, p.19.

employees[8]. The general adoption of TEE would avoid fiscal transfer problems (see above). Finally, a switch from TEE to EET would involve a substantial revenue loss (and a switch the other way a substantial revenue gain: NLG 15 billion in the case of the Netherlands).

In any case, the Commission envisages the co-existence of the different systems for some time to come, and suggests practical solutions other than harmonisation.

- Double-taxation problems could be avoided through the conclusion of double-taxation treaties such as those between Denmark and Sweden, or the US and Canada.
- Tax avoidance problems could similarly be solved through agreed exceptions to the principle of taxing pensions on the basis of residence, as provided for in the tax treaty between the Netherlands and Portugal.

The results of the Green Paper consultation, however, show that there is a sharp division of opinion as to whether such bilateral arrangements will be sufficient. While most Member State administrations believed bilateral agreements to be "*the only realistic solution"*,

> "*most of those representing the financial sector stress[ed] the disadvantages of such an approach: partial coverage of many bilateral arrangements, proliferation of texts, different treatment of identical situations, difficulty of subsequently switching to a multilateral approach, etc."*

A counter-suggestion from Member States to meet these objections was to give the Commission a co-ordinating role, "*for example, by issuing guiding principles to be embodied in bilateral agreements.*"

4.2. Tax relief on contributions

The Commission's approach to the issue of whether contributions paid into a pension scheme in another Member State should qualify for tax relief on the same basis as those into a domestic scheme is more robust. It argues, in effect, that Community law already requires this to be the case. The Commission declares that it will monitor Member States' rules and

> *"take the necessary steps to ensure effective compliance with the fundamental freedoms of the EC Treaty, including bringing the matter before the Court on Justice on the basis of Article 226…"*

Besides citing the Treaty provisions on the free movement of workers, free movement of establishment and free movement of services and capital, the Commission paper refers extensively to judgements by the Court: notably, the Bachmann ruling of 1992 (Case C-204/90); the Wielockx ruling of 1995 (Case C-80/94); and the Safir ruling of 1998 (Case C-118/96).

The case law results in a situation which is not entirely straightforward. In the Bachmann case, the Court held that the Belgian legislation in question – which made the tax-deductibility of contributions conditional on their being paid to a Belgian institution – was in principle contrary to the Treaty. It also held, however, that such a restriction might nevertheless be justified by the need to preserve "*the cohesion of the Belgian tax system*": i.e. that deductibility of contributions was linked to the eventual taxation of the pensions.

In the Wielockx case, the Dutch government sought to justify its refusal to grant tax deductibility to a non-resident by reference to this cohesion principle. It was unsuccessful; but the reason given by the Court was that the Netherlands had entered into bilateral tax

[8] See S.C.J.Van Weijnbergen, "Nederland weer aan het werk", *Economisísch-Statistische Berichten* 7, November 1998, quoted in *Pension Systems in the European Union,* Kluwer Law International, 1999.

agreements under which it had voluntarily surrendered any link between tax-deductibility of contributions and the taxation of eventual benefits.

The tax treaty in question was based on the Article 18 of the OECD Model Tax Convention, which, the Commission observes, is the basis of "*the large majority of Member States' tax treaties*". But it also draws attention to the fact that "*a few Member States seek in their treaty negotiations to introduce source State taxing rights over pension benefits paid to non-residents…*"

In conclusion, the Commission observes that some Member States already *do* allow tax-deductibility on contributions to non-domestic pension schemes. In other cases it is the Commission's view that the refusal of deductibility is "disproportionate".

However, the Commission paper also draws attention to two other factors, in addition to the "fiscal cohesion" principle, which complicate the position further.

4.2.1. The definition of "tax-approved" schemes

All Member States allowing the tax-deductibility of contributions to an occupational pension scheme apply certain conditions as to the soundness and suitability of the scheme. These cover such matters as

- the nature and level of benefits,
- the age of retirement and arrangements for early retirement,
- qualifying beneficiaries, and
- the standards of prudential supervision.

The definition of a "tax-approved" scheme, however, is not the same in all Member States.

The issue therefore arises: should contributions to a pension scheme in another Member State be tax-deductible if it conforms to the "tax-approved" rules of its own country, but not to those of contributors' country?

The principle of "mutual recognition" would imply: yes. The Commission's answer, however, is that

> *"Member States are entitled to require that such schemes meet the conditions applied to similar domestic schemes.."*

4.2.2. Limits on deductibility

Similarly, Member States generally set limits to the level of contributions which can qualify for tax deduction. One such rule, quoted by the Commission, limits total tax-deductibility to a level of contributions which will provide total pension receipts, taking statutory and occupational pensions together, no higher 70% of final pay. Here again, however, rules vary.

Problems can therefore arise when an employee, already in an occupational pension scheme in one Member State, temporarily becomes a migrant worker in another Member State where the rules on permissible deductibility are different. Should the employee be able to continue making tax-deductible contributions to the home-country scheme on the original basis?

Here the Commission's answer is: yes. Any restrictions would be of a fiscal rather than prudential nature, and would therefore fall under the scope of the Bachmann and other judgements.

4.3. The transfer of capital

When an employee moves from one company to another, the question arises: what should happen to his or her accrued rights in any occupational pension fund? The effective alternatives are:

- to "freeze" the accrued rights until retirement; or
- to transfer the capital sum into an occupational scheme with the new employer.

The main drawback of the first alternative is that a pensioner who has frequently changed jobs during working life may be drawing benefit from many different funds, and that total payments may turn out to be considerably less than if there had been membership of a single fund (for example, because of the relationship to final salary).

The problem with the second alternative is that, as the Commission points out, it is often "*difficult or even impossible*". In addition, where the employee has moved from one Member State to another, there can be an added tax problem – the Member State from which the capital sum is being moved may require tax to be paid equal to the amount of exemptions on the original contributions.

The Commission states that such situations "may be" contrary to the Treaty: notably where the value of pension capital is taxed on cross-border transfers, but not domestic transfers.

4.4. The Taxation of Pension Payments

Benefits paid from a pension fund based in one Member State to a pensioner resident in another are normally taxable in the country of residence. Under the OECD's Model Tax Convention, this is the case even if the source country has earlier "lost" revenue by allowing tax-deductibility of contributions. The situation therefore gives rise to a fiscal transfer between countries (see section 4.1).

Adherence to the terms of bilateral tax agreements means that a country must accept this situation (see the Wielockx judgement). There is, however, another problem: how can the country of residence be sure that pension payments from a fund in another country are properly declared for tax purposes?

The perceived danger to revenues does not principally arise in the case of those who have worked in one country, but retired to another. Rather, it is the possibility that those who *both work and reside* in one Member State will nevertheless participate in a pension scheme based in another. Such a situation can arise simply because an employee works for a firm based in another Member State.

In the case of payments within the *same* Member State, the Commission notes that national tax laws usually

> *"impose an obligation on domestic pension institutions to inform national tax authorities of any payment of pension benefits, and in some cases to deduct tax at source."*

One solution would therefore be for a similar obligation to exist in relation to cross-frontier payments. This could be organised on an "exchange of information" basis, similar to that now proposed in the case of bank and other interest paid to non-residents (the former draft "Withholding Tax" Directive). The Commission notes that the necessary legislation is already in place in the form of the Mutual Assistance Directive[9]; and proposes consultations in the

[9] Council Directive of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (77/799/EEC), OJ 27.12.1977, L 336, p.15.

Committee provided for in the Directive's Article 9(1) to agree detailed arrangements for information-exchange on occupational pensions.

Nevertheless, the "Witholding Tax" experience indicates that proposals in this field can prove politically sensitive.

4.5. Pan-European Pension Funds

One alternative answer in the case of employees who reside in one Member State, but work for a company based in another – and in particular those who work for a multinational company – has been suggested by the European Federation for Retirement Provision.

This would involve the possibility for companies operating in more than one Member State to set up a "pan-European pension fund", to which employees working anywhere in the EU could belong. Such a fund would:

- be based in one Member State only; but
- have different sections, corresponding to the Member States in which the company had employees.

The fund would be managed in such a way that each section would comply with the tax regulations of the Member State in question. Where tax was due – on investment yield under an ETT system, or on benefit payments under an EET or ETT system – the fund would collect the necessary tax and pay it to the appropriate tax authority.

Pan-European pension funds would eliminate a number of problems. For example, employees would no longer risk having a final pension made as a series of separate payments from different funds in different Member States. The final pension would be aggregated from the rights acquired in the different sections. Nor would there be any need to make cross-frontier transfers of capital.

One potential problem would be the allocation of assets between sections. Ideally, the assets of a pan-European fund would be managed as whole to maximise performance. In order to comply with the differing tax rules, however, it would probably be necessary to allocate the assets to the different sections. It is suggested that this should be done on the basis of the corresponding, actuarily-calculated pension liabilities.

The Commission notes that the European Federation for Retirement Provision proposal was developed as a solution for a single company operating in more than one Member State. However, it observes that the idea is capable of a much wider application. Pan-European funds might be established independently of any particular company, and provide occupational pension schemes for several companies "*or entire sectors or professions*". They would provide a general alternative to systems of information exchange, and at a lower cost in terms of administration.

Accordingly, the Commission

> *"invites Member States to explore with it how the proposal…could be made operational."*

Annexe: The Ageing Factor

Measures to promote the development of occupational pensions within the European Union must be seen within the broader context of pension systems as a whole. The Commission Communication on *The Future Evolution of Social Protection from a Long-Term Point of View: Safe and Sustainable Pensions*[10], noted that Member States, despite differences in approach, shared "*crucial problems*". In essence these were that:

- As a result of higher welfare standards, better medical treatment and lower fertility rates, the number of older people is set to rise in relation to people of working age (the "old age dependency ratio" - see Table 4).
- The critical factor for the sustainability of pension schemes, however, is the "economic dependency ratio": that is, the number of older people in relation to people actually in work. Currently, the number of people aged 20 and over *not* in work as a proportion of total employed is 0.86 in the EU as whole: i.e. there are almost as many adults not working as are working (see Chart).
- Hence part of the solution to the economic dependency problem is to *"reduce the number of inactive among the working population*". In practice, this means such measures as discouraging early retirement and raising the number of women in employment. In 1999 the average EU employment rate was under 60% (though with wide variations between countries: see Chart). The Lisbon European Council in mid-2000 established that, on the basis of a 3% economic growth rate, a total average employment rate of 70% should be achieved by 2010, with over 60% in the case of women.
- Linked to the dependency trends is the potential threat to fiscal stability posed by state pension commitments. Old age and survivors' benefits represent some 45% of total EU social protection spending, equal to 12% of GDP. For most Member States, this budgetary item is set to rise, in so far as future "Pillar 1" pensions take the form of commitments to future public expenditure. The projected fiscal positions of Member States therefore vary not only as a result of demographic factors, but also as a result of significant differences in such commitments. Simulations indicate that, in most Member States, public pension expenditure is set to rise by between 3% and 5% of GDP during the next 50 years[11].
- A number of ways exist to reduce such potential budgetary problems; and all Member States are, to a greater or lesser extent, engaging in reforms to their pension systems.

Reductions in current budgetary deficits and debt levels in order to build up a "cushion" against future pension commitments. This is the policy recommended by the Commission in the context of the Stability and Growth Pact and the Broad Economic Guidelines procedures. Its Report on the implementation of the 2000 BEG stated that

> *"Several Member States (Belgium, Spain, France, Ireland and Finland) have created or announced the establishment of pension reserve funds that will be used to offset some of the future increase in age-related expenditures. While this is a welcome development, these reserve funds, with the exception of Ireland, remain relatively small in relation to the budgetary impact of ageing populations and need to be supplemented with other policies".*

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[10] COM(2000)622 of 11.10.2000

[11] See Quintin, O. *Making Pensions Sustainable - the approach of the European Commission*, Brussels, November 7 2000.

A reduction in future public expenditure commitments through such measures as an increase in the retirement age and a change in the benefit indexation formula: e.g. by linking pensions to the price level rather than to average incomes, as in the case of the UK pension reforms of the 1980s.

In conjunction with such a reduction in budgetary commitments, **a switch to "pillar 2" and "pillar 3" provision**, possibly on a mandatory basis in the case of occupational (pillar 2) schemes.

PAYG, Funding and Risk

Virtually all Pillar 1 (and also a number of Pillar 2) pension schemes operate on the basis of "pay-as-you-go": that is, current pensions are paid out of the contributions made by current workers. One result is that any shortfall in receipts to pay current benefits can result in an increase in the level of current contributions[12]. But such a rise in "non-wage labour costs" can, in turn, lead to an increase in unemployment and a worsening of the economic dependency ratio.

As a result, one critical advantage advanced for Pillar 2 (and Pillar 3) provision is that such schemes are, for the most part, fully funded: that is, current contributions are invested in assets, and current pensions paid out of the income generated by those assets. This factor, however, is subject to two important *caveats*.

1. It is important to bear in mind that a shift from public “pay-as-you-go” schemes to occupational or private funded schemes *does not alter dependency ratios*. Future pensions, whether paid out of contribution and taxation or through income from investments, must still be financed out of future production.

   A key factor, therefore, is the extent to which the growth of Pillar 2 and 3 pension schemes generates capital for productive investment, producing a higher growth rate than would have been the case with public/PAYG systems.

2. The second factor is *the relative level of risk*. In the case of public PAYG systems the principal risk is that of default, similar to that in the case of sovereign debt. Complete default is highly unlikely in the case of any EU Member State; but "partial default" – for example, a change in the conditions and expected level of pensions – is not.

   In the case of Pillars 2 and 3, the risks derive from the nature of the assets in which funds are invested. Where occupational schemes are organised on the basis of book reserves, there is a risk that the company in question will become insolvent. Where a fund is separate from the balance sheet, but subject to management control there is a risk that the assets will be mis-used (as in the case of the Mirror Group Pension Fund in the UK). Finally, all invested assets are subject to the fluctuations of the financial markets. A switch from Pillar 1 to Pillars 2 and 3 does not necessarily mean that the State's ultimate financial responsibilities will have ended.

[12] The alternatives are a rise in general taxation or of budget deficits, or a reduction in other public expenditure.

Table 4: Old Age Dependency Ratios, 2000-2050

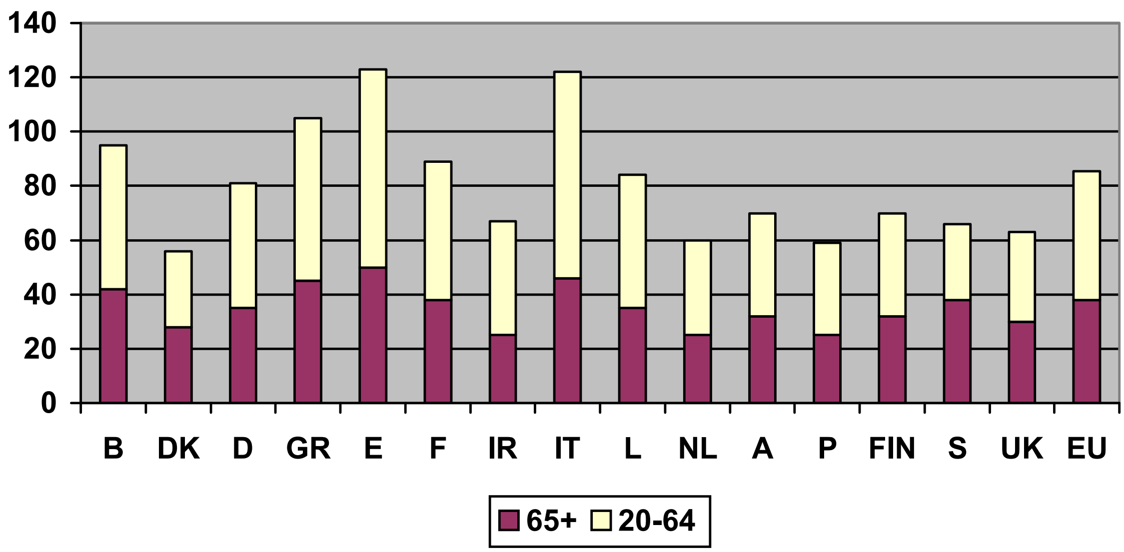
Calculated as the numbers aged 65 and over divided by the numbers aged between 20-6

%	*2000*	*2010*	*2020*	*2030*	*2040*	*2050*
B	29.5	31.1	38.0	48.8	53.5	52.0
DK	25.5	29.6	35.7	42.0	47.0	43.7
D	28.0	34.1	38.6	50.3	57.0	56.1
EL	30.2	33.6	38.0	44.4	54.7	61.6
E	28.7	30.7	35.2	44.7	59.8	68.7
F	28.5	29.5	38.1	46.4	52.1	53.2
IRL	20.3	20.5	26.2	32.1	38.4	46.6
I	30.7	35.5	42.1	52.9	67.8	69.7
L	24.8	27.6	33.0	42.5	47.2	43.5
NL	23.1	26.2	34.7	44.2	50.1	46.9
A	26.3	30.1	34.5	47.0	57.0	57.7
P	26.7	28.5	32.2	37.2	46.3	50.9
SF	25.9	29.7	41.4	49.5	49.7	50.6
S	30.9	33.8	39.8	45.4	48.9	48.5
UK	27.8	28.5	33.9	43.1	49.1	48.5
EU-15	28.3	31.4	37.3	46.8	55.0	55.9

Source: COM(2000)622), Commission Communication of 11 October 2000.

Chart: Economic Dependency Ratios (1999)

Population 20 and over not in work as % of total employed



Source: COM(2000)622), Commission Communication of 11 October 2000.

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