The economic implications of the EU Commission's pension proposal

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Abstract Ageing populations and falling birth rates are making pension reform essential. The Commission's directive on pensions aims ultimately to enable firms and individuals to manage their pensions as though the EU were one single country, breaking down tight government control over their own pension industry. The directive will start by allowing the proportion of funds invested in equities to rise and promote competition among asset managers to reduce costs and charges.

This directive is only a beginning. The biggest impediment to pan-European pensions has to be how pensions are taxed. In some countries saving for a pension is untaxed but the pension when it is drawn down is liable to tax. In others, contributions come out of after-tax income but payments in retirement are tax-free. If Europe is ever to have an open market on pensions then a uniform tax system must be introduced.

Some EU governments have already begun to reform their own pension systems, others remain opposed. A patchwork solution is emerging. Private pension provision within the EU is still small since only 25 per cent of EU working people have any private pension provision. The fund management and pensions provision industry is nevertheless excited about the prospects. Ultimately the opening up of the private pensions market means growth opportunities for the industry as well as a positive stimulus to the underlying economy, but much still needs to be done to win support for change.

Keywords: *EU Directive; pension reform; ageing populations; minimal private pension provision*

The pensions issue in 1991

Harmonising European pension systems has been steadily growing in importance for the EU Commission but the first attempts at this foundered. The EU first tried in 1991 to tackle the restrictions which impede cross-border investments

and which hamper any company wishing to pool its various national pension fund assets in a single fund. The 1991 draft directive hit a brick wall of opposition from almost all EU countries. A second attempt to break these down was made in 1993 when the original draft was

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amended, but this also failed and eventually the whole scheme was scrapped. Pension reform and the liberalising of the European pension market was one of the European Commission studies that was put to one side when the Commission resigned in the wake of massive scandals in 1999.

Now the Commission is trying again. In October 2000 the Commission brought out a new directive on pensions, backed by a stronger drive to see progress on this issue achieved. The Commission wants a sweeping overhaul of the existing regulations to help both individuals and companies to take advantage of the single currency, creating a single market in financial services by 2005. The fundamental aims are to protect pension holders, to provide basic investment rules and to open the domestic savings industry to healthy international competition. Why should the new drive succeed where previous ones failed? The Brussels initiative on pensions comes at a time when national governments are themselves seeking out ways of resolving their own potential pensions crises. There are alarm bells over the impending dangers of ageing populations and falling birth rates making national governments less likely to put up the kind of brick wall of opposition that scuppered the earlier attempts at European pension reform.

Governments appear unwilling to face the problem

In the 15 countries of the European Union, the population overall will not change much between now and 2020, but the number aged between 25 and 50 will fall by an eighth, from 139m to 122m. Today the percentage of the population aged over 65 is around 15–16 per cent in most European countries but over the next 35 years the numbers of pensioners are set to rise to half as much again or

more. As a result, spending from the public purse on pensions is also set to rise from around 10–11 per cent to between 11 per cent and 17 per cent. Even as they stand, these numbers are frightening enough. The figures for Britain stand in contrast to most of the rest of the EU. Although the number of people aged 65 and over is set to rise by 57 per cent, the amount being spent on pensions is set to rise to only 5.5 per cent of GDP. Michael Teitelbaum, a demographer at the Alfred P. Sloan Foundation in New York, has said, 'There is a different cause in each country. In Italy it is because women are delaying marriage and stretching the generations over more years. In Germany, it is a long-standing collapse, and nobody really knows why.' Italy's low birth rate means a likely fall in the population from some 57m today to 41m in 2050, a much faster collapse than the decline in the Roman Empire.

There is a fear that government forecasts could be seriously underestimating the extent of the ageing population problem. Many official forecasts assume life expectancy will increase much more slowly than in the past, an assumption which may well be wrong. They therefore project a higher percentage of populations will be young people and a lower percentage will be older people. If this is correct, then official forecasts overestimate the size of future working populations. Table 1 looks at possible solutions to the problem of providing for the increasing numbers of those at retirement age.

There is no one solution which would completely solve the problem, not even increasing the average retirement age by ten years or more. If governments insist upon holding benefits and tax rates constant, then by 2030 retirement would have to start at the age of 78 in Japan, at the age of 74 in France, 73 in Italy and 72 in the USA. By 2050, in order to

Table 1

Possible solutions to the problem of providing for the needs of the retired	Difficulties that go with the solutions	Would the impending crisis in coming years be averted?
Raising taxes generally or contributions paid by employers and employees in order to cover the rise in pension spending	This is no long-term solution and would impose a damaging financial burden upon firms and working people	No
Obliging working people to save and provide for their own old age, ie, the State opts out of its current responsibilities	This solution ultimately should work. Since each individual saves for his or her own pension, changes in the size of the working population should not cause future strain, but the important point is that this solution requires an efficient pension investment and management system.	This does not prevent a crisis with regard to those who will retire from work in the next ten or 15 years and who have placed their trust in the old systems.
Increasing the workforce supporting pensioners by encouraging immigrants to settle in the country	This is invariably only a temporary solution because immigrants' birth rates generally fall to match that of the host country and do so within a generation. Furthermore, large influxes of immigrants frequently generate racial tensions and social problems	Because immigration is only a temporary solution, this merely delays the problem
Increasing the workforce by persuading women to have more children	There would be the sensitive issue of whether any official moves to encourage larger families constituted discrimination against women wanting to work. To be effective, persuasion would certainly have to include financial support for mothers from the government	It is too late for this to prevent a crisis within the next ten to 30 years

keep current levels of benefits and tax rates, the age at which people stop working would have to be 81 in Japan, 78 in France, 79 in Italy and 75 in the USA. A study by PriceWaterhouseCoopers entitled 'New Europe: The European Pensions and Savings Revolution' came to similar conclusions.¹ This study found that the German and Italian state pension schemes would need an increase in the retirement age to 70 and 72 respectively if contribution rates remain the same and benefits continue to be linked to earnings. By the year 2030 in Italy employees would need to contribute 48 per cent of their salaries if the pensions budget is not to explode.

Europe has begun to draw in immigrants in order to maintain growth and living standards. Yet no government is willing to come clean about this for fear of protests. Immigration from developing countries has already produced social tension in most European states and the press in most countries is ever ready to fan the flames of that tension. The UN Population Division has estimated that if Britain wants to have in 2050 the same PSR ratio² between the population aged between 15 and 64 years and the population aged 65 and over as exists now, then Britain would need net immigration of more than 1m immigrants a year, and by 2050 the overall population would reach 136m, of whom some 60 per

Table 2

	Income tax rise* %	Overall tax rise** %
France	64.0	6.9
Austria	55.0	18.4
Spain	45.0	14.5
Germany	29.0	9.5
Italy	28.0	10.5
Britain	9.5	2.7
Denmark	6.7	
Ireland	-5.0	2.1

* The amount by which income tax rates would have to rise to ensure that pensions commitments are met

**The increases in overall taxes that would be required to maintain generational balance, ensuring that the as-yet-unborn pay roughly the same in tax as current working people

cent would be post-1995 immigrants or their descendants. Similarly, if Germany wants to have in 2050 the same PSR ratio of working people to older people as exists now, then Germany would need 3.4m immigrants every year and by 2050, 80 per cent of the population would be foreigners or their descendants. However, if these immigration figures are unacceptable and if Britain wants the same PSR ratio in 2050 without increases in immigration, then the retirement age would have to rise to 72.

The way forward

The way forward for EU-wide private pension provision will reflect a mass of pulls and tugs which will mean that the final pattern may well reflect inconsistencies or concessions to different country needs. The ultimate opportunities for the pension fund industry will be shaped by this pattern.

In trying to assess how the Brussels drive on pensions will ultimately take shape, it is necessary to recognise there are strong national pulls, which are likely to impede progress. The fund management and pensions provision industry is currently growing excited about the new possibilities that the wave

of change could bring in its wake, but the industry needs to temper its excitement and to recognise that the final pattern will ultimately be something of a patchwork mixing together European ideals with what the different EU countries regard as national imperatives. Different countries have different preferences both in terms of acceptable solutions to the ageing problem, and in terms of what each government can persuade its own electorate to accept.

The European Federation of Retirement Provision (EFRP), which represents the EU's leading pension funds, has expressed its fears that the proposals would impose too many regulatory burdens, yet at the same time would be shot through with 'get-out clauses' for the major countries, such as France and Germany. Systems that would not be required to follow the directive would include pay-as-you-go systems (such as in France) and state guarantee systems (such as in Germany).

On a pragmatic level, how great are the potential opportunities for the pension fund industry and where the opportunities lie, as well as how long it may take to bring these changes about, will depend upon this patchwork. It is therefore worth pausing to consider what factors will go into shaping this patchwork. But the gains in those financial centres that win out are likely to be considerable. The British pension industry already stands in a strong position. British pension schemes account for 42 per cent of all EU pension assets. The Danish and Dutch schemes add another 26 per cent on top of that.

The EU Commission's target

The EU Commission's ultimate target is an ambitious one, which is likely to need years, even decades, to achieve.

Frits Bolkestein, of the European Commission for taxation, has laid out his campaign. He wants to break down the impediments to cross-border pensions and ultimately (but not yet) he wants both firms and individuals to be able to manage their pension affairs anywhere within the EU as though the whole European Union were one single country. Just as a firm with branches in Munich and Hamburg is able to set up one single pension scheme for all its employees, so the aim is that a firm with branches in Munich and Madrid can do the same. Similarly, the individual whose career takes him from one country to another should not have to suffer as a result of his pension system being fragmented. This is the ultimate aim.

However, the Commission is well aware that national governments are not ready to accept so drastic a move yet. Governments have to reduce dependence upon public pension systems slowly enough not to cause panic among their citizens. The EU Commission, in tackling the issue of a single market for financial services and pensions, is for the time being holding back from recommending full portability of personal pensions. The EU is expected to tackle issues such as asset matching and the tax barriers to contributions. Further, rather than impose quantitative rules and limits upon national governments and private pension providers, the Commission deems that a 'prudent person' framework would be more appropriate. The Commission has set out four objectives in the first instance:

- to ensure the security of pension beneficiaries
- greater affordability and efficiency
- cross-border membership
- level playing field between providers.

Because of the difficulty in obtaining the

unanimous backing of all 15 EU states that is required in taxation matters, Bolkestein plans to adopt what he calls a 'soft' legislative approach. That is, using existing single-market rules and tacking tax agreements between states on to existing double taxation agreements is the best way to generate consensus on the issue. New legislation could take years to come into effect, but it is hoped that concrete results within a manageable time span can be achieved using existing single-market rules (these are supposed to guarantee the freedom of establishment in the EU and freedom of movement of persons, goods and services). It will nevertheless be difficult, as the experience with introducing a common system of taxation for cross-border savings shows.

Frits Bolkestein sees it as in the interest of the people who pay premiums that pension funds should make investments as freely as possible — providing that there is adequate supervision. The resistance of national governments is keeping the cost of providing private pensions higher than it need be. But Bolkestein is not prepared to allow national governments to block progress indefinitely, and he is advocating going to the European Court of Justice to make governments end discrimination against cross-border pensions, if need be.

Changes in the EU directive

Two big changes are envisaged in the EU directive on pensions: lifting the ceiling on investments in equities to 70 per cent and raising the ceiling on investing in another currency than the fund's own currency to 30 per cent.

How constrained the industry is in terms of investment possibilities varies enormously. British and Dutch funds are free to invest in a 'prudent' manner, so long as they do not invest more than 5

per cent of the fund in any sponsoring company. German funds have to meet no fewer than six separate limits: not more than 30 per cent in EU equities; or not more than 25 per cent in EU property; or not more than 6 per cent in non-EU equity; or not more than 6 per cent in non-EU bonds; or not more than 20 per cent in overall foreign assets. In Denmark and Austria pension funds may invest up to 40 per cent of the funds they manage in equities; in France the limit is 25 per cent. How much of pension funds may be invested in equities has long been a very thorny issue, since most national governments impose strict restrictions upon investing in equities which forces pension funds to invest a high proportion of funds in government bonds. The EU is proposing that the ceiling should be 70 per cent.

Another proposed change is that pension funds will be allowed to hold up to 30 per cent of their investments in currencies other than the one in which they have commitments. This will give the large international firms an advantage because they have global research and management capabilities, particularly with equities. The third aim of the Commission's directive is to achieve EU-wide competition for asset managers and custodians and this is intended to bring about a substantial reduction of costs and charges.

It has been estimated that overall in Europe there is around 2.3trn euros' worth of funds under the management of the pension funds. Experts have forecast that this could rise to over 3trn euros by 2005, a 30 per cent increase, and given that currently only about 25 per cent of the EU workforce is covered by private pension provision, such an increase does not appear implausible. Private pension provision within the EU is still relatively small — 2.3trn euros under

management of pensions funds compared with 4.5trn euros managed by the insurance industry.

Fewer limits on what pension funds may or may not do would mean a better performance. Studies carried out by the Commission found that where there were fewest restrictions, between the years 1984 and 1996, the annual real return on pension fund investments was on average 9.5 per cent. Where there were strict limits upon pension fund investments, the average annual real return was 5.2 per cent, a little over half.

The problems faced by national governments

National governments not only have to grapple with finding common ground on the matter of pensions, but most face electorates scared of what pension reforms may mean for them.

However, national governments face very different likely reactions from their own citizens. In some countries there is acceptance that state-provided pension systems will not be sufficient to provide for a comfortable old age and workers are increasingly seeking to provide for their retirements. In other countries there is entrenched resistance to all efforts to persuade people to top up their pensions. The danger is that this variation could drive a further wedge between countries. But governments that have already started setting up private pension systems may be reluctant to go back to square one and make major changes to their systems. This leaves open a very real possibility that national governments will each try to win universal support for the line that they have chosen to follow and most national governments will, to a greater or lesser degree, be reluctant to adapt their own system to that of some other country or countries.

Where the idea is accepted that

private provision has to come and growing numbers of workers are paying into some kind of pensions savings programme, the equity markets are substantially boosted. The funds that workers pay into are, for the most part, collective equity investments and the flow of money into the equity market boosts the collective wealth of those countries.

On the other hand, what is likely to engender hardline attitudes is the fear of tax competition. Countries with relatively high levels of taxation and similarly high levels of public services — including pension provision and support for the elderly — fear the globalisation of commercial activity, which could bring about the migration of wealth-generating organisations or individuals to countries where the tax regime is milder. In its turn, this tends to leave behind the population that is likely to make heavy demands upon public services.

Thus, the very wide variation among EU member states in current arrangements could act as a brake upon progress as well as leading to dissension among EU governments as to what is appropriate and what is not. It is worth looking at the present situation in the major EU countries.

Progress on pension reform in Germany

There are strong hopes that the German economy will see substantial benefits from the government's pension reforms, even though the first moves in reforming private pensions in Germany have been small. The German government has announced that the launch of private pensions will go ahead in 2002 but the distribution of costs between the generations will, 'by way of a contribution to be made by current

pensioners, not alter to the detriment of the younger generation'. However, the draft did not make clear how this 'contribution' would be made.

The state pension is to fall by 2030 to 64 per cent of final salary instead of the present 70 per cent. The Labour and Social Affairs Minister, Walter Riester, originally wanted to reduce state pension levels to 54 per cent of final salary by 2030, and not 64 per cent. The aim is to persuade German workers to put aside regular savings in a private pension fund. Individuals will be able to invest tax-free 1 per cent of their income in private pension funds. By 2008 the limit will have risen from 1 per cent of income to 4 per cent of income. The government has assigned DM 20bn in tax breaks and subsidies to encourage Germans to open private pension funds voluntarily. But the key point of the reform — that the state pension should fall from around 70 per cent of wages to 64 per cent by 2030 — has come under attack from left-wing parliamentarians arguing that reducing the state pension to 64 per cent will force many elderly people into poverty.

Riester's original plan was presented in June 1999, at the same time as the German Finance Minister, Hans Eichel, presented his austerity package aimed at bringing the government's fiscal deficit back into line with earlier commitments. The Riester scheme involved making private pensions compulsory for workers — employees would be obliged to pay a small part of their wages for a number of years into a private pension scheme, alongside the state scheme. This idea provoked a very hostile reaction and the plan was dropped — but not forgotten — and the Labour Ministry has been working on the revised scheme that was presented to parliament in November last year. Progress has been very slow for there is strong and deep-rooted dislike within the country for the whole idea,

and not just among workers and ordinary people.

The initial reaction from the pension industry has been negative, too. The government is also insisting that pension schemes will have to pay out at least the sum paid in as contributions. The German investment industry is strongly opposed to this last requirement. It amounts to insisting that pension plans must not lose money, a guarantee which the industry says would contravene existing German legislation. There is disappointment that the government has abandoned plans for changing over to a system of 'deferred taxation', that is, pensions are taxed but not contributions. It would seem that what the government is aiming at is shifting on to the private sector a small portion of the state system and constraining the private sector to very limited number of options, all of which will be subject to close government regulation. The reforms that Riester is proposing merely contain, rather than reverse, the explosion in costs resulting from the ageing of the population. Nevertheless Berlin officials are assuming that around 90 per cent of the 35m people who pay into the state system will eventually set up additional private pension provision.

At the end of October 2001, the German Finance Ministry insisted that it would not relax the rules on what would qualify for tax breaks under the planned pension reform package. Only bank deposits, investment plans and pension insurance policies guaranteeing a regular retirement income would be entitled to the proposed incentives. The types of pension schemes that will be eligible to qualify for state help must pay a life-long pension as well as guaranteeing to pay out at least as much as is paid in. Nevertheless, even this much would have been unthinkable only a few years ago.

Progress on pension reform in France

In contrast, in France various moves both by the government and by the employers' association have tended to do little other than spark off a flare-up of resistance. It is not true that the French government has not looked for ways of introducing private pensions, but few other governments face more active opposition to any such moves. The previous government under the leadership of Alain Juppé hit serious trouble with the electorate in its efforts to reform the pension system back in 1995 and this was a major factor in bringing down Juppé's government. However, in February 1997 the French *Assemblée Nationale* adopted a bill to allow the creation of private pension funds. Employers paying into private funds on behalf of their employees would be exempted from social security charges on those contributions. The take-up, however, was minimal. Then towards the end of 1998 the government decided that it would form a special reserve fund to cope with growing problems in the state-run pensions scheme. The announcement by Martine Aubry, the then-Employment and Social Services Minister, was intended to give advance warning of the government's resolve in tackling the problem. In 1999 the Prime Minister, Lionel Jospin, commissioned two reports on how to fund the pensions deficit. Jospin has also promised that the government would inject funds into Martine Aubry's small pension reserve fund. But real reform of the system effectively has been delayed until after the 2002 elections.

For 50 years employers and unions have worked together to oversee the administration of France's annual social spending on family allowances, old age pensions, supplementary and invalid pensions, health insurance and

unemployment benefits — all very much pay-as-you-go systems. Union representation on the boards of these funds has given the unions in France far more clout than their membership would appear to justify, given that little more than 5 per cent of the workforce is unionised. But the employers have long wanted to see the system changed, in particular they want to see a serious alleviation of the burden upon jobs — the current funding system places total reliance upon employee contributions which are a percentage of earnings. Employers would prefer to see social security funded directly out of general taxes and not by high company contributions, which they believe inhibits the creation of jobs.

At the beginning of 2000 the employers' organisation, *Medef*, threw down the gauntlet when members of *Medef* voted overwhelmingly for the withdrawal by employers from their joint role in running France's social security funds. Withdrawal by *Medef* would force the government itself to take over direct control over the day-to-day management of the social security system and its payments. This would probably cost the government more than it costs the employers, who, in many cases can get accounting and management functions carried out by the appropriate departments in their firms, but the government could easily find it needed to set up a body to do the same work. The current funding system places total reliance upon employer and employee contributions which are a percentage of earnings and thus a tax upon employment. These contributions are not small and *Medef* believes that they inhibit job creation. *Medef* wants the funding to come from general taxes. *Medef* would appear to be forcing the government to speed up the promised modernisation of the current arrangements. One of the

issues that has been facing the French government for some time has been whether to bolster the current system, whether to start up some kind of supplementary system for some or all of the social benefits provided, a system that would operate alongside the original system, or whether to seek a new system and largely scrap the old, or at least phase it out for all except the worst-off in the country. *Medef* all along has been extremely careful to make it clear that its objections were to the system 'in its current form'. The official reaction was rather cautious — the government said that *Medef's* stance could endanger important aspects of the Jospin agenda, especially pension reform and wider share ownership. By and large both the government and the unions have done all they could to resist recognising what a monster the social security system in France has become. The trouble is that reforming it will be neither quick nor easy. Since then *Medef* has announced that its members would stop paying their 40 per cent contributions to a supplementary pensions fund set up in 1983 for people who choose to retire at the age of 60.

Progress on pension reform in Italy

In 1999 public spending in Italy on pensions constituted 66.1 per cent of overall welfare spending and 'for the first time overall pensions spending exceeded the level of pension contributions', according to a report from the state accountant's office. Public spending on pensions stood at 15.0 per cent of GDP in the same year, which was up from 14.7 per cent in 1998. The financial newspaper, *Il Sole 24 Ore*, said the rise in the pension spending-to-GDP ratio was a failure for the last major overhaul of the pension system in 1995. At that time the

government declared with it would stabilise pensions spending as a proportion of GDP.

There have been three goes at reforming the Italian pension system, each named after the leader of the government at the time of its implementation — Amato, Dini and Prodi. The 'Amato reform' of 1992, the first of the three, set about switching to public pensions increasing in line with price increases rather than increasing in line with wage increases. In order to sweeten the pill for the Italians, the government allowed that the pension of anyone who had worked for over 15 years in 1992 would continue to be indexed to wages according to the old calculation. The 'Dini reform' moved towards a defined contribution system and from 1995 onwards pension benefits began to be linked to the level of contributions accumulated over the years and to the average expected life-span after retirement, rather than to earnings at retirement age. Again the change did not affect those who had worked for over 18 years by 1995; their pensions would continue to be calculated according to the old earnings-based method, while for the rest only for the period after 1995 would pension benefits be calculated according to the newly-introduced defined contribution system. Thus, these changes, while significant because they changed the underlying principles of the system, were to be introduced only gradually and hence the savings expected from them would only fully be realised after a considerable amount of time had elapsed. The third reform, the 'Prodi reform' extended the changes to those who worked in the public sector, who had so far retained all the privileges of the old system.

The argument today in Italy focuses on whether the compromises should go

or not. Should employees with over 18 years of service in 1995 continue to get special treatment, or should their benefits be calculated on the basis as everyone else? Also the Centre for Research on Pensions and Welfare Policies based in Turin believes that it should be possible to opt out of the state pension system altogether, a move which is likely to appeal to the young. This change would have the advantage of reducing pay-roll taxes which currently stand at approximately 33 per cent.

Change in the pensions industry

The whole private pensions industry is growing increasingly impatient with the regulators. The industry sees enormous opportunities for itself, as well as benefits to end-users. The industry, too, is driving for change.

Just as the drive for reform in France is very much in the hands of the employers' association, *Medef*, so large firms and the pension industry itself are a major force pushing for the introduction of private pensions and for the opening up of the pension industry Europe-wide. Over a year ago there were indications that the pension industry itself might force the Commission into speeding up action. PEPA (the European Pension Association), which was formed in June 1998, wanted to see a test case brought to the European Court of Justice and was willing to back any company prepared to bring such a case.

There is not one EU country which does not regulate its own pension industry tightly, regulations which work to impede the free movement of labour and push up the cost of providing for people's old age. Every EU country imposes restrictions upon its own pension industry while keeping out the pension fund management groups of other countries. To take the matter to the

European Court would require taking up the cudgels against the tax authorities of whichever country the test case were fought in. It would also require one company to go into the firing line and bring the test case before the courts. There may be big savings down the line from pension reform but in the short-term a national tax authority would be able to be obstructive over the discretionary decisions and tax law interpretation that companies would inevitably face. So while the industry is eager to see progress, most firms would like to see some other firm lead the way. PEPA found that initial interest evaporated with growing belief that confrontation would harm the companies involved. In fact, PEPA ended up having to reimburse 12 companies which had expressed interest in the proposal to bring a test case and push it right through to the European Court of Justice.

Pensions reform

Firms in particular would benefit if they could set up a single pension fund for all their employees no matter in which country they were employed. Individuals who choose to work in different EU countries would also gain.

Top industrialists in Europe have frequently pressed for radical reform of national pension systems. Ford, for example, has calculated that it could save around 40m euros a year if all its European employees were in one pension scheme.

The European Round Table, a grouping of 47 European multinational companies, published a report, 'European Pensions: An Appeal for Reform'.³ It called on the EU first and foremost to lift regulatory barriers to asset diversification by fund managers. It also argued for taxes applied to cross-border

pension contributions to be harmonised and for legislation to allow employees to take their pensions with them when they go to another country to work. This currently represents an impediment to the free movement of labour in Europe, since for many ordinary working people working in another country tends to mean that they lose pension benefits or rights, or that the full accumulation and consolidation of their pension funds is not achieved, the European Round Table wants governments to do more to encourage individuals to save for their own pensions with tax breaks and private pensions schemes, which it would like to see made fully portable.

The European Round Table also urges national governments to focus pensions spending upon the needy only. This may ultimately be where pension systems will have to go, but no government can risk telling its electorate that. The outcry from voters who would feel that they have been defrauded of the monies they have put aside towards their pensions through their social contributions would be enough to bring at least one government down.

What are the changes that national governments are most likely to resist?

The financial aspect is the biggest factor behind governments' reluctance to impose upon their apprehensive electorates a much greater obligation to provide for their old age.

In order to encourage the take-up of private pensions, governments will need to offer tax incentives which impact upon fiscal budgets. Governments will need to offer tax breaks for those who save in a private pension scheme if they are to win support for changes like these. Given the intensity of opposition among EU citizens to private pension provision,

governments anxious to take the 'softly-softly' approach find themselves faced with continuing to provide to older people the pension benefits promised, while effectively bribing younger people into taking on private pension plans. From the fiscal point of view, governments end up paying more in the immediate future in order to reduce the role of the state later on. Taken all together a sudden and large jolt to public finances could well occur.

There is a real danger here of governments sending out a message to their electorates that those who reach retirement with not a coin in their pockets will be bailed out and provided for by the taxpayer, and those who forego current spending in order to save for their old age will lose out. They would lose out not just because they have saved, but also because they are likely to be taxed upon the pensions that they have saved for, and out of their taxes will come the support given to those who did not save. Yet to make saving attractive enough with tax breaks that really mean something to the saver and to avoid this danger would almost certainly for most European governments cost more than they are willing to consider.

Not only would governments have to offer carrots to encourage their electorates to take seriously the need for private pensions, but also if any changes to the system have to be imposed that would place some savers at a disadvantage the government would need to compensate for that.

For example, some European countries allow saving for a pension to go untaxed and then tax the pension when it is drawn down. Britain is an example. In other countries, such as Germany, contributions have to be paid out of after-tax income but the payments in retirement are tax-free. Clearly, there is a

disincentive for British workers to go to Germany unless they are envisaging living out their retirements in Germany as well, but not the other way round. If the EU is serious about having a single market for labour and free movement of people and workers within the region, then it is disincentives like these that will need to be addressed. Moreover, if Europe is ever to have an open market on pensions then all EU countries would have to agree to either one system or the other. The Commission will ultimately seek agreement so that the same tax treatment of pension contributions is applied everywhere in the EU but such is the likely opposition to this from national governments that it may take decades rather than years to reach this goal.

Those countries that had to change might find that they had to pay compensation to any member of their electorate who lost out because of the change. Governments will have to recognise that those who save for a pension must be assured of the same benefits no matter where they chose to be living when they draw their pension. Today most employees lose pension rights when they relocate to another country. Frits Bolkestein has said that he believes that it is of great importance that citizens and companies outside their own countries should get the same tax benefits as nationals when using the services of a pension provider in another member state. The Commission wants to stop anomalies such as is found in Belgium where employees whose pension fund is located in another EU country are not eligible to claim tax relief upon their contributions, although such relief would be available to them if the fund was managed in Belgium. But so far there has been no progress in terms of making it easier for those who go to work in other EU countries, who

pay into schemes there but later retire and draw down their pensions somewhere else. The Commission is bringing a case against Finland over discrimination against cross-border pensions but this is still in the early stages.

The possible impact upon government fiscal positions and upon the bond markets

Governments fear the impact upon their own financial position. At present governments largely require private pension funds to place a high percentage of their funds in their own government bond market. Thus, governments currently benefit from having a captive supply of funds. Allowing private pension funds to invest far more in equity markets will reduce the amount of capital invested in government bond markets. Private pension funds that are free to place capital where they see fit would be likely to choose to switch investments to where better returns can be made and this would frequently mean out of national government bond markets. (Indeed, the Commission's own studies estimate that if pension funds are entirely invested in bonds, then the cost of an average pension needs to be 15 per cent of salary but were pension funds all in shares, then the cost of the pension is as low as 5 per cent of salary). Thus, increasing investment in shares reduces the cost of saving for a pension for the saver but would reduce the captive supply of funds available to national governments for borrowing, making it more expensive for governments to borrow. Thus, some governments might find it more expensive to service their debts if the pensions market were opened up.

Some governments are likely to remain steadfastly opposed to the idea of

pan-European pensions because of the likelihood that their own financial communities would not be competitive enough and would lose out to more advanced or sophisticated pension fund providers in another country. Deregulated private pension funds could easily seek to establish themselves where taxation is low while selling their services to citizens anywhere in the EU. Where the domestic private pension industry is too under-developed or not competitive enough, the business would be likely to migrate to other financial centres. This would also mean that the businesses, employment and tax revenues that emanate from the private pension fund industry would migrate to other countries that offer a better operating climate. Jobs locally would be lost. In some countries there would be a public outcry at this.

The countries with more developed private pension fund provision tend to be the countries where government debt is under some measure of control. This is the case in Britain where the supply of gilts is diminishing. For decades, life insurance companies and pension funds have relied upon a steady supply of gilts to cover their liabilities but increasingly they are complaining of a shortage of longer-dated gilts. They have long been demanding greater scope for their investments.

Competition drives a wedge between the more efficient and the less competitive

A recent paper published in the March/April 2000 issue of *Foreign Affairs* by Niall Ferguson and Laurence Kotlikoff, called '*The Degeneration of EMU*',⁴ is based upon the work done by Kotlikoff on generational accounting, that is, the fiscal burden that is being imposed upon future generations. Kotlikoff has

been working on what fiscal policies are needed to achieve 'generational balance' or ensuring that the as-yet-unborn pay roughly the same in tax as current working people. The most dangerous thing about their conclusions lies in the huge differences between countries. These differences risk setting one country against another. Tax harmonisation becomes a nonsense if pension funding were to require income taxes rising by 55 per cent in one economy and falling by 5 per cent in another.

Ferguson and Kotlikoff point to how in the past asymmetric fiscal problems, usually caused by war, cause monetary unions between independent countries to break up: 'The fiscal problems caused by bloated social security and pension systems could have a similar centrifugal effect on EMU, with welfare substituting for war as the fatal solvent.' Ferguson and Kotlikoff think that several countries might seek to leave the single currency. A nation breaking away from EMU and trying to inflate its way out of trouble would face higher interest rates, which would worsen its ability to service its debt. Its new independent currency would fall which would improve its economic competitiveness but foreign lenders would strive to get their debts repaid in euros. The report ends, 'The bottom line is that generational imbalances across the euro-zone gravely threaten the single currency's medium-term viability. The choice for nearly all EMU members is between tax hikes on a scale unprecedented in peacetime or drastic government spending cuts. Given the political weakness of most national governments, it is hard to see either choice being made. But the only other conceivable possibility — a sharp and unanticipated rise in inflation, which 'solved' some fiscal crises in the past — also seems

improbable, at least within EMU's constraints.'

Conclusion

For the financial industry the Commission's proposals offer huge opportunities and ultimately the greater efficiency should have positive effects upon the EU economy. But even with the decision to use soft legislation to push ahead, Frits Bolkestein knows that it is likely that progress will be halting and achieved only with difficulty. For national governments are pulled in two different directions. Most European national governments are well aware of the impending crisis of their ageing populations, but seem to be unable to find the political will to take decisive action. Because changes to pensions systems is so unpopular with electorates governments fear the effects of pushing ahead on their electoral support. Because the carrots needed to win electorates round (even partially) may well be expensive governments fear the effects upon their fiscal positions. Yet if national governments do not promote the directive then little will be achieved.

With Brussels driving the change, it is likely that slowly national governments will make progress in implementing the proposals. However, the opportunities that the pension industry is waiting to seize may be slow in emerging. For some time to come it is likely that the pension industry will gain only the freedom to spread their investments and increase the proportion going into equities or into non-national markets. But the emergence of pan-European pensions will take a great deal longer. Nevertheless, the development of the private pension industry ultimately should have a strong positive impact upon the economy.

However, in the near term a number

of adjustments will take place, particularly in government bond markets. Pressure on the fiscal balances of the governments that suffer from the loss of a captive source of funds, or where substantial tax incentives are needed to persuade electorates to accept the need for private pensions, may impact negatively upon those government bond markets. The study by Ferguson and Kotlikoff suggests that this negative impact would also weigh against the single currency. Nevertheless, the more certain the markets are that reform of European pensions will come about, the

less likely is this negative impact. Once the problem is perceived to be well on the road to a solution, European financial markets should become even more attractive to financial investors.

References

- 1 'New Europe: The European Pensions and Savings Revolution', published by PriceWaterhouseCoopers.
- 2 PSR = potential support ratio and is defined as the ratio of the population aged between 15 and 64 to that aged 65 and over.
- 3 'European Pensions: An Appeal for Reform', published by the European Round Table.
- 4 Ferguson, N. and Kotlikoff, L. (2000) 'The Degeneration of EMU', *Foreign Affairs*, March/April.