Original Article

The European Commission Green Paper on pensions: Lessons from the Dutch experience

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ABSTRACT The Dutch pension system is generally looked upon with admiration. It scores higher marks for level of participation, level of pension income and sustainability than retirement provisions of most other countries. The Dutch state retirement pension is funded as a pay-as-you-go scheme, second-pillar pensions are collectively funded and third-pillar annuities have a fully funded basis too. The Dutch retirement reserve equals more than 100 per cent of the country's GDP and 90 per cent of the workforce is entitled to a corporate pension. The Dutch practice of a 50/50 split between pay-as-you-go and funded schemes gives a robust and balanced outcome for beneficiaries. The 'EET'-system, that is, where pension contributions are exempt, accruals to the pension fund are exempt and actual pension income is taxed at the moment of payout, ensures that the tax revenue collected keeps pace with the ageing of the beneficiaries. Nevertheless, the Dutch system also has come under pressure where the Netherlands has to take measures like any other country. And this pressure, partly caused by the ageing population combined with the current and foreseeable economic conditions, painfully shows some of the shortcomings of the Dutch system. Does the Netherlands actually still have the world's best pension system? Maybe the Netherlands used to have sufficiently funded and well-organized pension schemes up until now, but this seems to be rapidly changing. This article intends to provide inspiring examples of dos and don'ts, which will give more insight in the Dutch system and could be useful for pension practitioners and policymakers in other countries.

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INTRODUCTION

The recent financial and economic crisis has triggered the international debate about

demographic trends, economic growth, public budgets, employment and the retirement practices in the world. As the European Commission has rightfully pointed out, the crisis has been the wake-up call for all pensions, either pay as you go or pre-funded. The promised retirement income has to be adjusted owing to higher

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unemployment, lower growth, higher national debt and financial market volatility. The recent public outcry in Greece, France and elsewhere on pension reform has been the latest results of the painful changes that governments have to make in their pension strategy.

'An adequate and sustainable retirement income for EU citizens now and in the future is a priority for the European Union'.¹ This is the opening sentence of the European consultation in 2010 on the European Union (EU) pension systems. This consultation (the so-called Green Paper) is an open consultation document in which the European Commission sets out fundamental policy goals. All interested parties were invited to submit their views until 15 November 2010. The Dutch government did so on 11 November 2010. Its response is approving in tone but reserved with regard to contents, arguing that the last thing the EU should do is interfere in the Member States' pension systems.

The European Commission's Green Paper focuses on the key challenges that the European Commission has identified in the complex and diverse EU pension landscape while noting that any EU initiative in this respect should be seen as a 'coordination' effort to deliver adequate and sustainable pensions. The Green Paper takes a very broad scope, ranging from economic developments to demographic trends and from social cohesion to financial market policies. The complexity of the EU pension debate is indeed unrivalled. There are substantial differences between EU Member States in terms of the structure of their pension systems. This complex landscape ranges from social security to private schemes, from occupational to individual schemes and from voluntary to mandatory schemes.

The problem of population ageing is not restricted to a single country; most European pension systems are under pressure. Generally, however, not enough has been saved to fund the pensions.

It would be rational, therefore, if the various governments focused their policies on encouraging people to save for their pensions. The tax system could help through the reversal

rule of delayed taxation. In a communication from April 2001, the European Commission expressed its support for wider application of the EET system, which provides for the deductibility of pension contributions and non-taxation of pension claims.² Full deductibility now will guarantee maximum tax revenues in the future, which by that time are likely to be indispensable to finance the costs of population ageing.

A system that provides for deduction of contributions in the present and taxation of pension payments in the future will materially result in a situation in which, notwithstanding costs and rate differences, the return on the net investment is available exempt from tax. This will encourage people to make pension arrangements of their own accord – an important effect in the overall trend to assign more responsibilities to citizens.

This article will hopefully contribute to the EU-wide debate on pensions, taking the Netherlands as an example, and focuses on risks and opportunities from the Dutch experience. The fact that the European Commission has opened the debate could perhaps be a stepping stone towards a more coherent approach, while the interests for the EU citizens are put forward as a priority.

THE EU TRENDS IN THE PENSION LANDSCAPE

The European Commission acknowledges that Europe's working-age population is set to start shrinking from 2012 onwards, combined with increased life expectancy. Whereas at present there are on average four working people for every person over 65 years, by 2060 this will be two working people for every person over 65 years. Furthermore, the European Commission flags the shift from pay-as-you-go systems (first-pillar unfunded public schemes) to pre-funded private schemes. Another trend is that the (financial) risks involved with pensions (investment decisions, inflation) are being shifted to the participant.

A shortage of labour is expected at the international level. Increasing the labour participation rate will help to mitigate the

consequences of this development for the market. In March 2000, the EU adopted an action and development plan.³ The strategy provided for raising the retirement age and gradually shifting towards a more robust system.

By removing obstacles in the area of pensions, the EU seeks to contribute more effectively to 'achieving a sustainable balance between the periods before and after retirement', enhancing pension security and stimulating the free movement of employees and capital.

THE CURRENT EU FRAMEWORK ON PENSIONS

The current EU framework for pensions focuses mainly on removing obstacles in the pension market and safeguarding the minimum social security in case of cross-border movement.

In this respect, we can mention among others:

- The EU Regulation 883/2004 and 987/2009.
- The EU Coordination Regulations on statutory old age pensions, survivor pensions and disability pensions.
- The IORP Directive 2003/41/EC.
- The Insolvency Directive 2008/94.
- Council Directive 98/49/EC on safeguarding the supplementary pension rights of employed and self-employed persons moving within the Community.
- Life Assurance Directive 2002/83/EC for insurance companies to operate throughout the EU and to establish and provide their services freely.
- Prudential rules overhauled by Solvency II Directive 2009/138/EC.
- UCITS IV Directive 2009/65/EC.
- Pension taxation Communication COM(2001)214 safeguarding tax relief for pension contributions paid to foreign pension funds.
- Dividend taxation Communication COM(2003)810: no discrimination on outbound dividends.

This current EU framework is mainly focused on the cross-border movement of individuals and on the cross-border activities for pension funds and insurance companies. But there is no

portability of the pension supplementary rights. The current framework is rather fragmented and does not lead to full realization of efficiency gains from economies of scale and competition and to more choice and protection for consumers. The lack of harmonization of prudential regulation and the complex interaction between EU regulations and national laws undermine an effective approach on the subject matter.

PENSION STAKEHOLDERS' PERSPECTIVE

The current system with 27 different EU jurisdictions provides for a wide variety of civil, labour and tax laws and different supervision and regulatory provisions.

In order for any coordinated initiative to be sustainable and supported by all stakeholders, one could try to define the basic conditions or goals for each stakeholder.

First of all, the requirement for any employee is to be provided an adequate pension income with a high level of transparency on the contributions, risks and pension benefits, while a maximum benefit from the contributions paid can be safeguarded.

From the perspective of the employer, pension fund and insurance company, there is the need for providing and managing pension rights for its employees on a global level with as little obstacles as possible, possibly by putting all pension obligations in one EIORP, maximizing economies of scale, reducing costs and pooling of assets and/or liabilities. The aim would then be for these stakeholders to be able to collect pension contributions free from EU obstacles, to provide asset management free from EU obstacles and finally to provide pension income to its EU-wide beneficiaries free from EU obstacles.

From a government's perspective, one could take several angles; from a tax revenue perspective, governments should facilitate an appropriate building-up of pension rights (tax deductibility of pension contributions) and ensure a proper taxation of pension income; from a social cohesion perspective, governments

should ensure an adequate pension income for its citizens; and from a supervision and regulatory perspective, governments should enhance possibilities to monitor investment strategies of pension funds and increase Solvency II-type rules, providing for qualitative and quantitative minimum standards.

THE DUTCH RETIREMENT PROVISION SYSTEM

The Dutch pension system is widely regarded as an example where sufficiently funded and well-organized pension schemes provide a balanced approach between first, second and third pillar. However, this is only part of the story. Also in the Netherlands, further steps are necessary in order not to further erode the pension base for current and future pensioners.

The Netherlands currently has a pension capital reserve of approximately €768 billion, and a population of 16 681 500. The reserve equals more than 100 per cent of the country's GDP. The system for retirement provisions in the Netherlands consists of three pillars:

1. State retirement pension (first pillar) – approximately 50 per cent.
2. Occupational pensions (second pillar) – approximately 40 per cent.
3. Private pensions (third pillar) – approximately 10 per cent.

State retirement pension (AOW) is funded as a pay-as-you-go scheme. This poses a risk in combination with an ageing population. Second-pillar pensions are collectively funded pensions (which tend to become risky when the inflation rate is high and/or the investment result is low). The individual contributions in the third pillar also qualify as a type of funded system. According to the experts, the Dutch pension system owes its robust and balanced nature precisely to this 50/50 split between pay-as-you-go and funded systems. The diversified funding system ensures that the risks of inadequate or unaffordable pensions are spread among, *inter alia*, active members and pensioners.

Having said that, the Netherlands will nevertheless have to take measures like any other country. This is not only due to the ageing population combined with low interest rates, but also due to a number of issues specific to the Netherlands – issues that other countries could avoid relatively easily. For instance, having a lot of complicated regulations is very cost inefficient.

State retirement pension (first pillar)

The Dutch General Old Age Pensions Act (AOW) was introduced in 1957. This insurance was made compulsory and is funded, in principle, from the employee's wage. Dutch state retirement pension is, in effect, a type of national insurance. First-pillar pensions are traditionally funded on the basis of income-dependent contributions (up to a certain ceiling), but all Dutch residents are insured, including those without any income.

State pension contributions

The state pension system is based on an accrual system of 2 per cent for every year that a person is a resident of the Netherlands during a fictitious active life of 50 years: a compromise between insurance/state pension and deferred wages. The insurance element is expressed in the contribution waiver for old-age pensioners. The deferred wages element was reflected in the fact that the state pension contribution was deductible, but this feature was abolished abruptly in the early 1990s. State pension contribution is now non-deductible, while the income is taxed: this implies a double levy.

Over the years, both the maximum percentage and the maximum contribution income tend to rise, as is shown in Table 1.

State pension benefit

The Dutch state pension is a relatively modest basic provision. It amounts to 70 per cent of the statutory minimum wage for a single person aged 23 years or older (€1525), gross €1067.47 (2011). For married or cohabiting partners, it amounts to 50 per cent (gross €743.60). This results in a net disposable income of €823.73 and €573.90 per person per month, respectively, after applying the available tax credit.

Table 1: State pension contributions

Sl. no.	State pension contribution		Maximum contribution income (€)	Maximum State pension contribution (€)	Compound interest (€)		Total (€)
	Year	Percentage					
1	1957	6.75	3.131	211	211	8	219
2	1958	6.75	3.131	211	431	17	448
3	1959	6.75	3.131	211	659	26	686
4	1960	5.50	3.381	186	872	35	907
5	1961	5.50	3.381	186	1.092	44	1.136
6	1962	7.00	3.744	262	1.398	56	1.454
7	1963	6.80	4.084	278	1.732	69	1.801
8	1964	6.80	4.821	328	2.129	85	2.214
9	1965	8.70	5.445	474	2.688	108	2.795
10	1966	8.70	5.786	503	3.299	132	3.431
11	1967	8.80	6.376	561	3.992	160	4.151
12	1968	9.00	6.966	627	4.778	191	4.970
13	1969	9.10	7.351	669	5.638	226	5.864
14	1970	9.50	7.918	752	6.616	265	6.881
15	1971	9.90	8.531	845	7.725	309	8.035
16	1972	10.30	9.597	989	9.023	361	9.384
17	1973	10.40	11.027	1.147	10.531	421	10.952
18	1974	10.60	12.139	1.287	12.239	490	12.728
19	1975	10.40	14.408	1.498	14.227	569	14.796
20	1976	10.40	16.155	1.680	16.476	659	17.135
21	1977	10.45	17.607	1.840	18.975	759	19.734
22	1978	10.45	18.945	1.980	21.713	869	22.582
23	1979	10.40	19.944	2.074	24.656	986	25.642
24	1980	10.25	21.055	2.158	27.801	1.112	28.913
25	1981	10.60	22.122	2.345	31.257	1.250	32.508
26	1982	11.05	25.888	2.861	35.368	1.415	36.783
27	1983	11.65	27.749	3.233	40.016	1.601	41.617
28	1984	11.65	28.520	3.323	44.939	1.798	46.737
29	1985	11.70	28.679	3.355	50.092	2.004	52.096
30	1986	11.35	28.928	3.283	55.379	2.215	57.594
31	1987	11.75	29.292	3.442	61.036	2.441	63.478
32	1988	11.50	29.609	3.405	66.883	2.675	69.558
33	1989	10.80	29.904	3.230	72.788	2.912	75.699
34	1990	14.30	19.115	2.733	78.432	3.137	81.570
35	1991	14.05	19.497	2.739	84.309	3.372	87.681
36	1992	14.35	19.497	2.798	90.479	3.619	94.098
37	1993	14.00	19.634	2.749	96.847	3.874	100.721
38	1994	14.13	19.634	2.773	103.494	4.140	107.634
39	1995	14.45	20.125	2.908	110.542	4.422	114.964
40	1996	15.40	20.568	3.167	118.131	4.725	122.856
41	1997	15.40	20.856	3.212	126.068	5.043	131.111
42	1998	18.25	21.411	3.908	135.018	5.401	140.419
43	1999	17.90	21.861	3.913	144.332	5.773	150.106
44	2000	17.90	22.233	3.980	154.085	6.163	160.249
45	2001	17.90	27.009	4.835	165.083	6.603	171.687
46	2002	17.90	27.847	4.985	176.671	7.067	183.738
47	2003	17.90	28.850	5.164	188.902	7.556	196.458
48	2004	17.90	29.543	5.288	201.746	8.070	209.816
49	2005	17.90	30.357	5.434	215.250	8.610	223.860
50	2006	17.90	30.631	5.483	229.343	9.174	238.517
51	2007	17.90	31.122	5.571	244.088	9.764	253.851
52	2008	17.90	31.589	5.654	259.506	10.380	269.886
53	2009	17.90	32.127	5.751	275.637	11.025	286.662
54	2010	17.90	32.738	5.860	292.522	11.701	304.223
55	2011	17.90	33.436	5.985	310.208	12.408	322.616

State pension is expressly intended as an income policy instrument: at the individual level, there is hardly any connection between the

amount and the spread of the contributions on the one hand and the level of the retirement benefits on the other. Table 2 shows that an

Table 2: State pension contribution compared to state pension benefit

50 years	1957–2006	238.517	State pension contribution plus compound interest						
	1962–2011	321.480	State pension contribution plus compound interest						
State pension 2011	Gross	Holiday	Wage tax	Health insurance premium	Net per month	Annually		Average 13.5 years of benefit	
						Gross €	Net €	Gross €	Net €
Single	1067.47	58.62	161.00	82.72	882.37	13.513	10.588	182.427	142.944
With partner	743.60	41.87	112.08	57.62	615.77	9.426	7.389	127.246	99.755

employed person who earns an average income will generally pay many times more in state pension contributions than he or she will ever receive in state pension benefits.

State pension funding

A situation in which fewer and fewer people are expected to fund contributions for more and more pensioners is inherently unstable. In 1998, the Dutch government created a statutory option to finance state retirement pensions in part from general resources (tax revenues). As a result of this strategy, old-age pensioners can effectively contribute to their own state pension benefits. It was decided to introduce a mixed funding system: a maximum contribution of 18.25 per cent topped up from general resources.

Many politicians in the Netherlands argue that state retirement pensions are no longer affordable owing to the ageing population. However, the real picture is different. A study conducted by the Netherlands Court of Audit⁴ in early 2008 showed that the working population in the Netherlands are paying more than enough state pension contributions on a cash basis to finance retirement provisions for the entire 65-plus age group (leading to a 'surplus'). Indeed, the study found that the contribution for working persons could actually be reduced to 13.2 per cent.

State pension and the pensioner

Individual citizens are rightly wondering whether there will be any state pension funds available by the time they retire, and whether there is perhaps a hidden agenda to abolish the state retirement pension altogether. What is done instead with the surplus of state pension contributions?

The traditional income tax allowance in the Netherlands was replaced by a tax credit in 2001. Since then, contribution income and tax revenues all flow towards a single fund from which the tax credits are deducted. This implies a shift of many billions in contribution income towards taxes. To ensure that all state pension payments can be paid from the remainder in full every year, money has to be refunded via a so-called BIKK procedure.⁵ These funds are wrongly referred to as a 'government contribution to the state pension'. In fact, the state does not make any contribution at all; it just sweeps surpluses.

The Netherlands has a progressive income tax rate comprising four tax brackets, the highest of which reaches 52 per cent. One further measure has been introduced 'to keep the state pension system affordable': the sustainability contribution, which means that only 75 per cent of the ceiling of the second bracket is indexed, instead of full indexation. This has resulted in a reduction of the second bracket and accelerated application of the 42 per cent rate of the third bracket. The sustainability contribution equals the difference between the rates of the second and third brackets, which is applied to the additional part of the income that comes under the third bracket with effect from 2011. The sustainability contribution does not apply to individuals born before 1 January 1946.

In a time of population ageing, people are understandably inclined to argue that each generation should be able to fund its own pension needs. It would nevertheless be perfectly reasonable to exempt the generations who have funded the state pension for people who never

paid any state pension contributions themselves. Otherwise, those generations would bear a fivefold burden: double taxation because of the elimination of the deductibility of state pension contributions, longer working lives and payment of the sustainability contribution 'to keep the state pension system affordable' (which it is anyway). Moreover, these are also the generations that funded the early retirement system for others (which has since been abolished). They are not likely to accept any reduction in their state pension.

Occupational pensions (second pillar)

There is no *general* mandatory occupational pension in the Netherlands. Second-pillar pensions have for many years been the domain of the social partners (employees and employers), united in a foundation: Stichting van de Arbeid (STAR).

Mandatory

There are, however, two types of mandatory pension in the Netherlands:

1. The 'minor' mandatory system.
2. The 'major' mandatory system.

Under the minor mandatory system, every employee who is subject to a collective labour agreement is statutorily obliged to join a pension scheme.

Under the major mandatory system, the Minister of Social Affairs and Employment, at the social partners' request, can decide to make it compulsory for all sector players to join one industry-wide pension fund. The major mandatory system may also be made to apply to self-employed individuals.

Industry-wide pension schemes are usually funded by a flat-rate contribution, which means that the level of the contribution and the pension accrual are the same for all participants in the scheme. The flat-rate contribution results in a redistribution in which younger participants subsidize the pensions of older participants. In this way, solidarity is organized between younger employees and their older colleagues,

healthy and sick employees, men and women, full-time and part-time employees, single persons and married or cohabiting persons, and between employers who belong to an employers' association and those who do not.

In several rulings from 1999, the ECJ considered this system not to be in conflict with EU requirements, owing to the solidarity aspect.⁶ The question is, however, whether the ECJ will still arrive at the same conclusion in 2011, because employers, in accordance with the EIORP Directive, should be allowed to accommodate their pension schemes with pension administrators in another Member State. The fact that the EU eventually aims to achieve a common insurance market is another circumstance that makes it doubtful whether compulsory sourcing practices will be allowed to continue for much longer.

Pension fund or insurance company?

Under the Dutch law, occupational pensions must be accommodated with either a pension fund or an insurance company. Insurance companies are liable to corporate income tax, whereas pension funds are not. To maintain a level playing field, the Dutch legislator has clearly demarcated the tasks of insurance companies from those of pension funds. This demarcation serves a dual purpose.

1. On the one hand, the *product-related* demarcation ensures that pension funds only provide pension facilities agreed between the employees and their employers and characterized by a specific (minimum level of) solidarity.
2. On the other hand, the *domain-related* demarcation restricts the possibilities for employees to join pension funds. Until 11 June 2009, corporate pension funds could not relate to more than one company or group. Industry-wide pension funds can only serve the companies that belong to the specific industry concerned. The domain-related demarcation between insurance companies and pension funds prevents the creation of larger and cross-sector groups (which diminish the costs per participant).

Government guidance and facilitation

The government facilitates retirement pension provisions. A pension equal to 70 per cent of the employee's most recent wages has traditionally been deemed to be acceptable and desirable. Note that this *includes* first-pillar state pension payments. It has been compulsory for state pension to be incorporated into the pension since 1957.

$$\begin{aligned} 70\% \text{ wage} &= \text{pension} + \text{state pension} \\ &\Leftrightarrow \text{pensionable earnings} \\ &= \text{wage} - 10/7 \text{ state pension} \end{aligned}$$

Under tax facilities available until 1 June 1999, up to 1.75 per cent pension could be accrued per year of service (that is, 70 per cent after 40 years of service). Since 1 June 1999, the 70 per cent level can be achieved in only 35 years and can be exceeded up to 100 per cent or more in certain circumstances.

The final pay pension scheme generally results in an adequate pension, although technically it qualifies as an open-end scheme.

Government intervention

In the 1960s and 1970s, participants in the largest Dutch pension fund, Civil Service Pension Fund (ABP), which has managed the pension contributions of Dutch civil servants since 1922, paid 25 per cent in self-funding contributions towards a prosperity-linked pension (that is, indexation based on wage inflation). Now that they have retired, these people may find that their pensions are not adjusted for inflation, not even according to the price index. Over a 25-year period, with an inflation rate of 2 per cent, the value of a pension that is not indexed will fall by around 40 per cent. Note that this problem results in part from the fact that from 1982 the contribution percentage to be remitted to ABP was consistently reduced so as to create savings to reduce the government deficit. This practice resulted in a funding shortfall at ABP, which was calculated to amount to NLG 32.86 billion in 1992. ABP was then privatized as of 1 January 1996.

In 1989, the Dutch government introduced a draft bill for a Levy on Pension Funds' Capital Surpluses Act, which granted pension funds a buffer of 15–18 per cent, depending on their investment policy. The bill aimed to tax NLG 19 billion in pension capital deemed superfluous. Pension funds with a capital surplus on their books would face a 40 per cent levy, unless no pension contributions had been paid in the preceding year. The government not only wanted to prevent a high funding ratio, but also, and explicitly, aimed to encourage the non-payment of pension contributions. The bill was never actually passed, but was only definitively scrapped from the political agenda in the twenty-first century. We would now have been extremely happy with those 'surpluses'.

Furthermore, in 1997, the Dutch government and STAR signed the 'Occupational Pensions Covenant', the principal objective of which was to control pension costs. The central idea was that the increase in structural costs resulting from the 'trend towards greater flexibility and modernization' of supplementary pension schemes should be compensated within those schemes themselves. Since then, final pay schemes have been converted into average pension schemes on a massive scale. The proportion of active participants in final pay schemes was nearly 70 per cent in 1998, and fell to 49.3 per cent in 2003,⁷ 3 per cent in 2007⁸ and a mere 1.2 per cent at the beginning of 2008.⁹ At the beginning of 2003, 35.4 per cent of participants were covered by an average pay scheme, but at the beginning of 2008 that figure had risen to 81.7 per cent. During that same period, the proportion of defined contribution schemes rose from 2.3 per cent to 4.9 per cent.

Portability

In the past, many employees who switched employer would be confronted with a loss of pension rights. It was not until 8 July 1994 that a statutory right to the individual transfer of accrued benefits for employees who move to another employer was created in order to prevent such loss of pension rights. This change was accompanied by a multitude of laws and

regulations, as a result of which the transfer of accrued benefits is a laborious and expensive process. The rights to be assigned to employees must be actuarially equivalent. This concerns nominal pension rights; indexation capacity is not transferred. The pension provision is transferred on the basis of a value calculation method that is determined by the government and changes every year.

If pension capital is transferred to a pension scheme based on final pay, the employer may grant the employee fictitious years of service. In case of an average pay scheme, the employee can use the capital to purchase an additional pension amount. In case of a defined contribution system, the transferred capital is used as a contribution for a future pension.

In final pay schemes, in addition to transfer of pension rights, an increase in salary may result in back-service costs with respect to fictitious years of service with other employers. In addition, since 1 January 2000, it has been mandatory for those back-service costs to be financed directly.

In part, as a result of the statutory right to transfer pension provisions, many pension schemes changed from a final pay system to an average pay system or defined contribution system, resulting in a lower pension.

From a social perspective, making the topping up of a pension shortfall conditional upon the transfer of a pension provision is not a particularly effective approach. The link with the transfer generates a variety of problems, including high administrative costs and compulsory additional payments.

Portability interest rate differences

Before 1999, all pension administrators were allowed to use an actuarial interest rate of 4 per cent. On the instigation of the supervisory authorities, since mid-1999, insurance companies have used a compulsory actuarial interest rate of 3 per cent. The lower interest rate resulted in a 20–25 per cent increase in costs.

Initially, pension funds continued to use the 4 per cent actuarial interest rate, but in 2008 they switched to a variable market interest rate. The capital to be transferred is calculated on a market

value basis, with the applicable interest rate covering the full calendar year. The discount rate was 4.926 per cent in 2008, 4.533 per cent in 2009 and 4.122 per cent in 2010, and it will be 2.984 per cent in 2011.

In transfers from a pension fund to an insurance company, owing to the difference in actuarial interest rates in recent years, the transfer value has been lower than the part of the rights to be financed. Given that after the transfer the employee is entitled to an actuarially equivalent pension, this could result in substantial additional payments on the part of the new employer.

International accounting standards

The current national trend in the Netherlands is in favour of defined contribution systems or more hybrid schemes.¹⁰ This is partly the result of IAS 19, under which it has been compulsory, since 1 January 2005, for listed corporations that apply a defined benefit system (pension based on final pay or average pay, that is, other than a defined contribution system) to apply a complex valuation system for assets and liabilities. For any identified deficit between pension liabilities and investments, a provision must be created and surpluses must be recognized as assets. The prescribed calculation method is expensive and causes a high degree of volatility in the balance sheet. It can be expected that in order to avoid this, employers will increasingly shift towards a defined contribution pension system. In such a system, it is not the employer but the employee who bears the investment and inflation risks, which could be another reason for companies to adopt it.

Annuities (third pillar)

Whereas a pension is agreed between an employer and an employee, an annuity is an agreement between an insurance company and an individual.

Government facilitation

In the Netherlands, certain annuity premiums are deductible up to a certain maximum; annuity payments are subject in full to a progressive tax rate, with the exception of transitional rules. Under the Dutch law, the funds collected by

way of retirement provision may only be distributed in the form of periodic payments. Full or partial surrender, disposal or pledging as security carries severe penalties. This partly accounts for the complex nature of tax legislation surrounding insurance products.

Administrative and commission costs

Insurance products accompanied by extensive complementary laws and regulations also involve considerable advisory, staff, service and handling costs. The legislator itself caused a substantial increase in the costs of insurance companies. Since 2001, the annuity regime or its associated laws and regulations have been amended practically every year. This process has also seen increasingly stringent obligations for insurers to provide information to consumers and tax authorities. However, in addition to the government the sector itself bears at least part of the blame.

The Dutch market features insurance companies that sell their products through the intermediary channel and those that do not (known as direct writers). Insurers in the latter category do not operate at significantly lower costs than those in the first. Direct writers spend more on publicity and information. The policy costs can be divided into initial costs and recurring costs. Initial costs include the policy preparation fee, other costs directly related to a specific insurance policy (such as the medical examiner's fee) and any initial commission, mostly based on the premium multiplied by policy duration. Recurring costs include collection and disbursement costs, handling fees, the costs of actuarial calculations, service for insured parties, change processing costs, fund costs for unit-linked products and maintenance commission.

In the Netherlands, intermediaries have traditionally operated on a commission basis, as it was determined that an intermediary's remuneration could only consist of a commission fee paid to the intermediary by an insurance company. However, that rule was withdrawn on 1 April 2002. Since then, insurance companies have been free to decide for themselves how they wish to remunerate their intermediaries.

Transparency and flexibility

The insurance sector has never been particularly open about commission fees and other costs, nor is the complaint about the insurers' tendency to charge high costs and lack of transparency of recent date; indeed, it was heard as far back as in the 1960s. This clearly has to do with the fact that insurance policies can only be taken out with an insurance company, a situation that qualifies as forced sourcing.

Partly due to high commission fees, only part of the contributions paid over the first years actually contributes to accrual. In fact, most of the costs that the intermediary and the insurance company expect to incur throughout the duration of the insurance policy are charged in the first few years – a fact that many consumers are not aware of. In many cases, this 'reduced allocation' far surpasses the direct initial costs. Throughout the first 12 years, the policy value is almost invariably lower than the sum of the contributions paid.

High switching costs are another major cause of the reduced allocation problem. Of course, this is incompatible with the idea of a free and competitive market. The lack of transparency goes some way towards explaining high switching costs. The intermediaries are the obvious party called upon to put an end to this lack of transparency. The problem is that their remuneration structure offers them no incentive to do so, nor to compete on the costs of commutation.

Having said that, complex tax rules, forced sourcing, high commission fees, reduced allocation and high switching costs are not the only causes of low commutation values. There are several different ways in which insurance companies make a profit on charges, not only upon surrender, but also with regard to changes to the policy, such as a split off (resulting in double the original charges), transfer to another insurer, and conversion into a paid-up policy. In addition, unit-linked policies often involve wholly or partly hidden fund costs. Many policyholders, moreover, have noticed that the prognosticated return figures stated in insurers' quotations are very different from the amounts

eventually paid out. This has resulted in an infamous profiteering policies scandal in the unit-linked insurance segment, complete with class action by consumers.

Supervision

In 2006, the Authority for the Financial Markets (AFM) – one of the supervisors of the insurance sector – also identified a number of shortcomings with a number of life insurance companies in the provision of information to consumers. This problem can be attributed to various causes, including the use of different administrative and actuarial systems for one and the same life insurance policy, programming errors, entry errors, actuarial differences and rounding-off differences. Generally speaking, the back-office systems of many insurance companies in the Netherlands are poorly managed. This is why consumers' questions are not efficiently answered (if at all) and why it may take months for changes to be processed. This complex of issues has resulted in serious reputational damage to the Dutch insurance sector.

As in the case of profiteering policies, the costs of pensions are often inordinately high. Indeed, it is thought that a 'profiteering pension scandal' might well outshine the profiteering policy scandal. In anticipation, the Dutch Association of Insurers, the National Ombudsman and STAR agreed on a 'profiteering pension standard' on 23 March 2010, which maximizes the costs that can be charged to pension contributions at 1.5 per cent of the funds invested plus 9.5 per cent of the contribution. As shown in Table 3, even with these maximum percentages the costs can still be significant.

Please note this does not include any additional costs of a waiver of contributions in the event of occupational disability, which normally amount to 5–8 per cent of the contribution.

It is safe to conclude, therefore, that both the Dutch life insurance market and the Dutch pension market seem to be non-transparent and not very efficient. Although increased EU interference is not a guaranteed cure, it is clear that the Dutch government itself has for many decades failed to make this sector operate more efficiently.

Table 3: Pension policy costs

<i>Policy duration (years)</i>	<i>Cost ceiling (in % of the contribution)</i>
10	16.5
15	20.5
20	24.5
25	27.5
30	31.5
35	34.5
40	38.5

Cross-border aspects

The authority to impose tax does not always accrue to the Netherlands with respect to individual pension or annuity beneficiaries who are no longer resident taxpayers but have moved abroad. Tax treaties often assign that authority to the taxpayer's country of residence, in accordance with the OECD Model Treaty. The Dutch state is willing to accept this, as long as the retirement pension is paid out in instalments and taxed to an adequate level. If not, the general feeling will be that the Netherlands has offered an unjustifiable tax facility. Parties that fail to adhere to the conditions attached to tax facilities risk a progressive levy of up to 52 per cent plus 20 per cent in non-deductible revisionary interest. In practice, it seems that administrative rules make international transfers even more expensive and unattractive than the national ones.

In recent years, additional measures have been taken to combat this type of tax avoidance. For example, the successive non-Dutch insurer/pension administrator is forced to assume civil-law liability for the payment of Dutch taxes and revisionary interest in cases of surrender, disposal, lending, pledging, release and so on ('irregular actions'). It is doubtful whether this measure is consistent with EU requirements.

The new treaty policy conducted by the Netherlands¹¹ aims to ensure that the source country retains the right to impose tax on pension and annuity schemes that qualify for tax facilities, or at least that the Netherlands retains its right to impose tax in cases of irregular action. This is not consistent with the OECD Model Treaty, nor with the principle that taxpayers

pay tax in the country where they reside, as that is the country whose facilities they use. In addition, assigning the right to impose tax to the source country is impractical and will increase administrative and collection costs, especially in the international transfer of accrued benefits.

As a general rule, the lower the number of participants, the smaller the risk spread and the higher the resulting cost per participant. As a result, from transfers towards third parties, the original pension administrator will not be able to benefit from any mortality profit either. From a sector perspective, therefore, insurers have little reason to encourage participants to transfer their accrued pension rights.

If pensioners are given the choice, they will prefer to emigrate from the Netherlands to countries with a more benign climate, such as France, Spain, Italy or Greece, than vice versa. Only fully funded pensions can be transferred. In countries without a fully funded system, the retirement pension provision will simply disappear in a 'black hole', from the Dutch point of view.

For these reasons, the Netherlands opposes the Portability Directive. Even if putting all your eggs in one basket would not be advisable under all circumstances, émigrés may nevertheless have good reasons to want to take their pensions along with them. At stake here are the participant's/pension beneficiary's interests. After all, this concerns the participant's pension and fundamental freedoms, which should prevail over the pension administrator's or State interests. .

Recommendations for the Netherlands

Relation to public finance?

As evidenced by its response to the Green Paper, the Netherlands clearly favours a system that promotes sustainable and adequate pensions *as long as this does not compromise the sustainability of our public finances*. In other words, public finances take precedence over the level of the pensions. This means that if push comes to shove, the government will probably use pensions to balance the budget. However, this is no different than in other countries, including

Poland and Hungary, where second-pillar pensions have only recently been privatized. Eastern or Western Europe, recently or less recently: apparently it does not make any difference.

Looking at the recent history of the Dutch state pension, ABP and the capital surplus levy it appears that the Dutch government indeed tends to view pension savings as public property rather than as the property of individual participants/pension beneficiaries. This is probably the reason why the Dutch government's response to the Green Paper implies that the last thing the EU should do is interfere with the Member States' pension systems. As formulated in the parliamentary papers, 'What we need to avoid is having Europe add to our existing problems or erode our own splendid pension system'.¹²

The Dutch government's reserved attitude is all the more remarkable in the light of the fact that within the EU this country was known for many years as one of the most fervent advocates of European cooperation.¹³

Lifting of restrictions?

A message to the Dutch government could be to abolish the product and domain-related demarcation between pension funds and insurance companies, as it obstructs a further increase in scale and poses an unnecessary obstacle for a free European pension administration market. It should be possible for employers to accommodate their pension schemes with the party that is able to administer them at the lowest cost. Abolition of the system of forced sourcing¹⁴ could promote the creation of larger cross-sector group schemes, and thus help reduce the costs per participant. If desired, employers should also be allowed to accommodate their schemes with pension administrators in different Member States, pursuant to the EIORP Directive. The current 'major' mandatory system obstructs the possibilities for non-Dutch pension insurers as they are not allowed to serve Dutch participants subject to the Dutch mandatory system. By abolishing this practice, the Netherlands would avoid being reprimanded by the European Commission in the evaluation of the EIORP Directive.

First pillar?

It would be a good plan to abolish the compulsory incorporation of the state pension. This practice is disadvantageous for employee categories such as low-income workers and part-timers; that is, it may have an indirect discriminatory effect, as it complicates the system and increases costs. The incorporation of the state pension is illogical, because people derive the entitlement to state pension not from being an employee but from being a citizen of the Netherlands. Incorporation makes occupational pensions less transparent for average citizens and, as such, makes people less aware of their pension situation.

Ultimate goal: Minimizing costs and maximizing pension results

Owing to a myriad of government measures, the costs of pensions have risen sharply in the Netherlands, despite the fact that the pension schemes themselves have actually been rationalized. This development is neither favourable nor desirable. Especially in times of population ageing, it would make sense to ensure that every euro contributed for retirement provisions results in a maximum output. Anything that would promote the affordability of pensions and lead to a higher pension yield is desirable. Anything that has the opposite effect should be avoided or at least reconsidered.

According to the study entitled 'Generation-conscious policy'¹⁵ published in 2000, solidarity as a basis for pension accrual is more efficient than individual accrual, especially when a pension fund aims to retain excess capital to pass on to subsequent age groups in the pension scheme.¹⁶ This is illustrated in a study conducted by the Dutch Association for Industry-wide Pension Funds,¹⁷ which revealed that the costs of Dutch pension funds between 2000 and 2004 amounted to approximately 4.4 per cent, compared with an expense charge and profit mark-up of around 23.9 per cent among Dutch insurance companies during the same period. In terms of costs, returns, flexibility, communication and service, pension funds offer the most attractive option from all the options available to employers.¹⁸

All the same, the number of pension funds has been falling for years. The Dutch government should make an effort to stop this trend and promote the rise of larger, cross-sector group schemes.

Cross-border portability?

In the recent years, the Netherlands has taken additional measures to combat tax avoidance and prevent émigrés from transferring and subsequently surrendering their retirement pensions. Perhaps the time has come, also in view of the increasing internationalization, to adopt a rather more relaxed attitude in this regard. In the United Kingdom, for instance, pensioners are allowed to surrender pension schemes above a certain level without this resulting in restrictions on the available tax facilities. What arguments do we have to prevent a person from using part of an old-age pension provision to redeem a mortgage loan, for example? Although the fixed and evenly distributed periodic payment component would be lost, this does not automatically imply that the pensioner also loses any means to provide for himself. After all, lowering your interest burden is just another means of increasing your financial capacity.

Supervision and regulation

The supervision of pensions and insurances in the Netherlands is divided between two separate authorities. The Dutch Central Bank (DNB) is responsible for prudential supervision aimed at safeguarding the solidity of financial institutions, and overall financial stability. The AFM's market conduct supervision focuses on ensuring orderly and transparent market processes, integrity in the relations between market parties and careful treatment of the end consumer.

These supervisors are exerting strong and increasing pressure on market players to put their management and internal organization on a more professional footing and take the required measures. However, the choices made are not always very appropriate. Examples include the compulsory actuarial interest rate and the excess capital requirements, which are more

stringent than elsewhere in Europe. They lead to significant additional costs and do little to strengthen the competitive power of Dutch players in the pension sector.

Another problematic measure is the obligation imposed upon pension funds to sell shares when their excess capital decreases. This measure had a procyclical effect and failed to contribute to the recovery of the Dutch economy during the recession. Unfortunately, a question not posed is whether all those supervisory measures do actually result in better pensions for participants. Before the introduction of the measures, most employees in the Netherlands were covered by final pay schemes plus *ex post* indexation. Clearly, a cost/benefit analysis of the measures taken is desirable.

LEARNING FROM THE DUTCH EXPERIENCE: RECOMMENDATIONS FOR A EUROPEAN APPROACH

First pillar

Concluding on the Dutch first-pillar experience, for most Dutch citizens state pension contributions do not match state pension benefits. Furthermore, the non-deductibility of the state pension contribution and taxation of state pension benefit income leads to double taxation. And finally, the current surplus on contributions is being used for other (non-pension related) purposes. Dutch citizens should not be kept in the dark on the current situation and the future of the state pension.

Second pillar

Concluding on the Dutch second-pillar experience, the mandatory occupational pension schemes in which all sector players are obliged to join one industry-wide pension fund seems to be contrary to EU requirements. A pension level of 70 per cent of final pay is considered adequate and is supported by government by tax deductibility of pension premiums. Pension funds are, however, not bound to ensure all pensioners an inflation-proof pension income. This means that any pension fund deficit can have direct consequences for the pensioners. In prosperous

economic times, with booming asset prices, the pension funds have reduced pension premiums, and the government initiated actions to tax the surplus values in order to reduce the government deficit. These interventions should be avoided or even be made impossible in future pension schemes. Another aspect is the portability of pension rights, which should be ensured on an EU level in order to provide the employers and employees a pension reality that is brought in line with their economic reality and necessity of cross-border mobility of employees.

And finally, the shift from defined benefit to defined contribution schemes where the burden of risk of the pension investment and inflation are being shifted to the participant should be accompanied with a high degree of transparency for the employee. This transparency should lead to a high awareness of asset allocation, investment strategies and minimum standards in low-risk asset management to safeguard pensioners that might not be able to comprehensive complex investment strategies that are being presented to them.

Third pillar

The third pillar in the Netherlands (private pensions) is a market, which is being provided by insurance companies in the form of annuity contracts between the employee and the insurance company. Given the very complex Dutch and frequently changing legislation on this topic, the administrative costs for insurance companies have been substantial, leading to an erosion of the deemed income for beneficiaries. Apart from the legislative burden, the insurance companies and the insurance intermediary system also led to contracts for consumers, which were not necessarily based on the best possible outcome. Transparency in this respect, relating to the administrative costs for contracts and commissions paid per contract, combined with more transparency in the asset allocation and investment strategies of insurance companies should be high on the agenda. A fixed ceiling of contract costs (as a percentage of the assets in the contract and/or a percentage of the contribution) could be the way forward.

European approach?

The world's economies are closely interrelated. This is true especially for the EU Member States that share a common currency. As a result, the design of budgetary policy in one Member State may influence the economic situation in other countries (the 'spillover effect'). As institutional investors, pension funds are major players in the financial markets. In Europe, pensions are seen as a growth market. Pension reforms will have to meet the requirements of the Europe 2020 strategy. Inevitably, Europe will assume controlling powers in this regard.

Participants at the G-20 summits in Pittsburgh and Toronto stressed that all financial institutions will have to be regulated and that more common rules are needed. Within the EU, increased financial supervision is deemed to be necessary if the current open internal market is to be maintained. This is why the solution tends to be found in more regulation and centralization. In this regard, the four new European supervisory authorities reflect a clear trend. It would neither seem wise nor necessary to maintain all sorts of national supervisory bodies in addition to these EU-wide regulators. Progressive harmonization of supervision in an international context is needed.

EU Member States could be forced to use mortality tables for the entire European population, that is, without distinguishing between country of residence or gender. This would promote cross-border solidarity, prevent gender discrimination and no doubt reduce administrative burdens.

Given the general tendency to place investment risks with the participant, it might not be a bad idea for the EU to issue minimum requirements for what should be offered for the contribution (bearing in mind the profiteering policy scandal).

The 28th regime proposal for a regulatory framework for a Europe-wide private pension scheme to supplement existing schemes should perhaps be given a chance, depending on how it is implemented in practice. It should, however, be explored in advance whether there is such a thing as an optimum scale for pension administrators.

As the current trend points to further individualization, pension schemes could be stripped of undesirable solidarity measures. Mandatory participation in a pension scheme could be accompanied by the free choice of administrator. That choice could be made at the level of the employee, the employer, the company, the national level or at EU level. However, one should keep in mind that if this choice is made on a higher level, more solidarity will be the result. And if the choice would be made on a more individual level, it would result in more custom-made arrangements, but at a higher cost. Enlightened self-interest can perhaps also result in spreading of risks and a choice for solidarity.

One of the EU's objectives is to close the gaps in pension schemes. One way of giving Europe the benefit of the doubt and deal with the EU pension issue in a constructive manner – with due regard for the principles of solidarity and group interests – is the following. One could consider to introduce a mandatory pension (throughout the EU) at a contribution rate equal for all employees from the very first euro earned as from 2012, to fund a dependant's and orphan's pension on a risk basis, and an occupational disability pension.

Experience has taught us that the contribution per participant is lower if the number of participants is higher. In this design, not just assets, but liabilities are also pooled. This means that such a fund could be created at relatively low costs, with the added benefit of giving the EU a better overview of active participants within its borders. If the EU manages the fund, it will be possible to invest in a variety of projects that are in Europe's best interest (monetary goals, major investments with a solid return on investment).

And last but not least: not a single dependant or orphan would be left unprovided for, while the problem of people with little opportunity on the labour market would be settled once and for all in a collective, social and relatively inexpensive manner.

If the EU proves to be able to manage such group schemes in a responsible manner, the

system could gradually be extended to include a mandatory retirement pension. That would concern future entitlements. To keep the system simple and transparent, it should not include any waiting times or thresholds, no minimum age, no state pension offset, no exclusion of low-income earners or part-timers, and no distinction based on gender. It would be unwise to maintain an EU-wide pay-as-you-go system. The mandatory nature of the system would be essential. Group schemes and solidarity are easier to organize under mandatory rules.

A WAY FORWARD?

One characteristic feature of the debate on the sustainability of pension systems is the multiplicity of possible approaches. In addition to demographic developments, the debate involves themes such as internationalization, the free market, mandatory regulations, certainty, stability, solidarity, expertise, pension awareness, administrative costs, affordability and taxation. This means that in effect any conceivable outcome of the debate could be rationalized.

The only effective EU pension system in the end would be a mandatory system, based on the following three guiding principles:

1. Adequate retirement pension provisions for all.
2. Minimizing costs, without compromising the quality of the eventual pension benefit (keep it simple).
3. The pensioners' interests must be considered a top priority.

Therefore, in order to determine any approach for EU citizens, a massive overhaul of EU legislation could perhaps be the only way forward. However, given the political reality in many Member States, and the strong scrutiny of the subsidiary rule, perhaps an incremental

approach (that is, approximating coordination of policies) rather than a comprehensive approach (that is, new EU legislation to provide a new EU pension scheme) seems more likely in the near future.

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