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Editorial

Is the European pension problem a tax problem?

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By the end of the previous century, it had become common practice to divide retirement pensions into three categories, or 'pillars'. The state pensions are the first pillar. They are provided by the state for the benefit of the entire working (and sometimes non-working) population. The second pillar comprises supplementary employee pensions. The scope of the second pillar varies from country to country, and is influenced by factors such as the size of the benefits from the first pillar. In most member countries, government tax legislation on employee pensions is limited to the application of the EET system. According to this system, premiums paid are not considered income, but the benefits are taxed in due course. No tax is levied during the accrual period. The third pillar includes supplementary provisions such as annuities, endowment policies and tied bank savings schemes. These are also referred to as private pensions.

Pensions used to be the preserve of a handful of experts, but that time is now past. Pensions are relevant to everyone – a employers, employees and governments alike. In the past year, the European Commission made no less than two important communications regarding pensions, one by Diamantopoulou and one by Bolkestein. Which of the two is the most important depends on whether you ask a tax specialist, an economist or a politician. It is only by reading both texts that you get any idea of what the real problems are. So what are the real problems? A tax specialist would name safeguarding taxation by Member States, international value transfer and licensing requirements for pension providers. For an economist, financing of pensions would come first. Are both right or partly right? The politician's answer might stress the stability of the Euro.

In October of last year, European Commissioner Diamantopoulou published the communication 'The Future Evolution of Social Protection from a Long-Term Point of View: Safe and Sustainable Pensions'.[1] This communication brought the issue of pensions to the attention of politicians. It was even discussed at the recent meetings of government leaders in Lisbon and Oslo. By now, politicians have begun to realize that pension financing in Europe is a time bomb that could blow up the social security system of the European Union, possibly even the Union itself. Without trivializing the tax problem, I believe that all that pension financing requires is a technical solution and a little political will. Financing pension commitments for which no reserves have yet been built up will prove more intractable. However, that is not a tax issue, but a matter of sharing the burden between generations. Can the current working generations be expected to pay the pension benefits for those already retired while at the same time saving for their own pensions?

The heart of the matter is that a number of countries have made pension commitments, but have not yet built up any reserves to meet them. The idea is that the working will pay for the retired, which is referred to as a pay-as-you-go system. There is nothing wrong with such a system in and of itself, provided there are enough working people to pay for the pensions of the non-working population. Only there are not. The specialist jargon for this phenomenon is 'increase in the dependency ratio'. Around 2015, the baby boomers will be turning 65. The demographic consequences of the post-war baby boom will be on the decline by 2030 and will have more or less disappeared by 2050. It is, therefore, a temporary and manageable problem.

An additional problem is that the number of young people is relatively low due to the reduction in the birth rate. Moreover, the older population are living longer due to better nutrition and health care than in the past. In consequence, pressure on health care costs will be high.

In her communication, Diamantopoulou mentions the limited employment participation of older people. On average, only 22.3 per cent of the population between 60 and 65 still work. In the 55 to 59 age group, this figure is 50.7 per cent. Seen against the trend of the past decades – that people retire earlier and live longer as a result of better living conditions and health care – it is clear that something has to give.

The most recent communication, published by Bolkestein on 19 April of this year, is entitled 'Tackling Tax Obstacles to Cross-Border Provision of Occupational Pensions'.[2] In it, Bolkestein paints the European pension landscape and gives his views on the pension-

[1] Communication by the Commission to the Council, the European Parliament and the Economic and Social Committee, COM (2000) 622.

[2] Communication by the Commission to the Council, the European Parliament and the Economic and Social Committee, COM(2001) 214.

related tax barriers in the EU and how to clear them. Most of his communication is music to my ears. A survey has shown that most Member States use the EET system. Just two countries, Germany and Luxembourg, offer no deductions and consider benefits tax-exempt. To indicate the importance of pension issues, it should be remembered that approximately 25 per cent of the labour force is covered by a company pension provision. In the Netherlands, that figure is 91 per cent! The size of pension reserves varies sharply as well. Pension reserves expressed as a percentage of the gross domestic product are 95 per cent for the United Kingdom, 5 per cent for France and 2 per cent for Spain! Many were disappointed that this communication was nothing more – that it was not a set of draft guidelines. However, the communication shows clearly what the European Commission thinks about the most important tax problems. Additionally, it served to give a new impetus to the discussion.

With the European Commissioner threatening to take Member States to the European Court of Justice if they do not alter their legislation (and allow pension providers who do not have their seat in the country in question to be considered as authorized insurers), accusations of power play begin to surface. Time will tell whether the European Commission has been too heavy-handed in this area. The mere fact that a communication has been made on such a momentous issue – a draft directive apparently being politically infeasible – deserves our wholehearted support. Once again, this issue has proved a stubborn one. According to the communication, a well-functioning internal market for company pensions is essential if citizens are to exercise their right, enshrined in the EC Treaty, to free movement within the EU, and therefore crucial to increasing the movement of labour. In the communication, Bolkestein outlines his views on the following tax issues:

- the relation between the freedoms laid down in the EC Treaty and tax impediments as seen, for example, in the context of international value transfer;
- guaranteeing the taxation of the Member States;
- pan-European pension institutions;
- different taxation systems operating alongside one another.

The Commission's standpoint on the conditions a number of Member States have placed on tax deductions for pension premiums is that such conditions constitute an impediment to labour mobility and cross-border pension schemes. This has to do with the so-called licensing requirement for pension providers, which is still in place in some Member States. According to this requirement, pension or annuity premiums are deductible only if they are paid to a life insurance provider that has its registered office in the Member State in question.

This licensing requirement has different aspects. First of all, it compromises the right of insurers to provide services without any impediment within the EU. Secondly, it is impossible for employers to have their pension commitments handled by a pan-European pension institution when they are confronted with cross-border employment relationships. Since 1 January 2001, the Netherlands has been safely within EU guidelines in this area, because the 2001 Income Tax Act, which took effect on that date, provides that premiums paid to a pension provider or annuity insurer not based in the Netherlands should be treated in the same way as premiums paid to a body with a seat in the Netherlands. The fact that some countries have not given up this licensing requirement – motivated by anxieties over losing their right to levy taxes – is rightly a thorn in the side of the Commission. The Commission considers such behaviour on the part of Member States to be inconsistent with the EC Treaty and invokes *Safir*, *Bachmann*, *Wielockx*, *Eurowings* and *Avoir Fiscal* to support its argument. Although the judge will decide in the end whether the Commission is right, the Commission has certainly given off a clear signal.

As regards safeguarding the application of Member States' tax rules, the Commission's opinion is that automatic exchange of detailed information is the best way to guarantee interests and promote a smoothly functioning internal pension market. I think this is the situation to aim for in respect of all types of social security benefits, but it will take some time. I anticipate that it will be difficult to get politicians to put this item high on the agenda, but that will not be the only obstacle; there is also the level of computerization of the relevant accounting systems in the various Member States.

One idea that I am less enthusiastic about is that of the pan-European pension institutions. I realize that a few words will not do justice to the philosophy and workings of a pan-European pension institution, but in a nutshell, the idea is that a pension provider would be based in one Member State but have just as many sections as there are Member States. Each section would stand for a Member State and the pension schemes handled would comply with the taxation and other requirements of that Member State. This makes it possible for an employer to place a pension scheme with a pension provider in another Member State. The great advantage of this is that multinationals can continue to pay premiums to the same institution if an employee is transferred to another Member State. The premium would just be handled by another section. Transfer of rights to another section would not be necessary, although a separate scheme would have to be set up for temporary posting.

As I have said, I am not enthusiastic about the pan-European pension institution. I can imagine a building – in Luxembourg perhaps – with 14 floors. Each floor has its own tax regime and each floor handles part of the pension scheme of a multinational. When employees retire, each floor pays out part of the pension, deducts withholding tax if applicable and informs the tax authorities about the pensioner's domicile. I see no efficiency benefits, and therefore no cost benefits, in such a scheme. I would prefer a directive which sets out a framework to which a pension scheme must conform in order to be EU-proof – with a certain amount of variation. A pension scheme which complied with the criteria would then be applicable in every Member State.

Because there are so many taxation systems for pensions within the EU today, frictions could develop. For example, if someone has built up a pension in a country where premiums are exempt and benefits are taxed, it would be very attractive for that person to move, on retirement, to a country where the premium is taxed and the benefit is entirely or partially tax-free. This would lead to tax migration. The reverse situation, where a person moves from a country where the premium has already been taxed to a country where the benefit is taxed, would be undesirable.

So where do the real problems lie? Not in the area of taxation, I would say. The problems we are facing in that regard can be solved by technical means, and with a little political will. The financing problems and the limited labour participation among older people will demand far more effort. Political courage, decisiveness and resolve will be necessary. For the rest, I wonder what will happen if the EU is expanded eastwards. Should we not first defuse this time bomb before we start thinking about expansion?