Cross-Border Portability of Pension Rights

An Important Condition for an Integrated Market for Pension Provision

CENTRE FOR EUROPEAN POLICY STUDIES

Report of a CEPS Task Force

Chairman: Elsa Fornero

Rapporteur: Jørgen Mortensen

CROSS-BORDER PORTABILITY OF PENSION RIGHTS:
AN IMPORTANT CONDITION FOR AN INTEGRATED MARKET FOR PENSION PROVISION

REPORT OF A CEPS TASK FORCE

CHAIRWOMAN: **ELSA FORNERO**
PROFESSOR, UNIVERSITY OF TURIN

RAPPORTEUR: **JØRGEN MORTENSEN**
ASSOCIATE SENIOR RESEARCH FELLOW, CEPS

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This report is based on discussions in a CEPS Task Force on Cross-Border Portability of Pension Rights. The members of the Task Force participated in extensive debate in the course of several meetings and submitted comments on earlier drafts of this report. Its contents contain the general tone and direction of the discussion, but its recommendations do not necessarily reflect a full common position reached among all members of the Task Force, nor do they necessarily represent the views of the institutions to which the members belong. A list of participants appears at the end of this report.

The Task Force gratefully acknowledges the contributions to the work of a number of speakers and discussants (also listed at the back of this report). We acknowledge in particular the important contribution of several Commission staff members to the debates. We would stress in this context, however, that whereas their views and assessments have influenced the positions of the Task Force, they do not necessarily share the assessments and recommendations contained in this report, which is published on the sole responsibility of the members.

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Centre for European Policy Studies
Place du Congrès 1, B-1000 Brussels
Tel: (32.2) 229.39.11 Fax: (32.2) 219.41.51
E-mail: info@ceps.be
Internet: http://www.ceps.be

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EXECUTIVE SUMMARY

General assessment

The lack of *pension portability* is a source of additional costs for European enterprises, both directly and indirectly, through loss of competitiveness and inefficient allocation of resources:

- Many multinationals are obliged to invent internal mechanisms to compensate employees previously benefiting from occupational (employment-related) pension schemes but who have lost their pension rights due to cross-frontier movements within the firm.
- Individuals moving to another EU country before full vesting of pension rights in an occupational pension scheme or "backloading" of vesting (see glossary) frequently are obliged to choose between two evils: leave the pension scheme in their country of origin or maintain this membership without being allowed to deduct the premiums from their taxable income in the country of residence.
- Lack of pension portability may induce multinational firms to abstain from moving employees to another EU member state or individuals to abstain from taking up residence in another country (and to change job within the country).
- In most EU member states, tax deductibility of premiums paid to pension schemes (including individual savings schemes) is allowed only if those premiums are paid to a pension scheme or insurance company located in the country. This segmentation of the pension markets (coming in addition to restrictions on the investment policy of pension funds) results in considerable hidden economic costs due to inefficient allocation of resources and fragmentation of the pension market.

With the specific aim of analysing and making recommendations with respect to pension portability, CEPS took the initiative in 2001 to convene a "Task Force", inviting participation from all the major players in the pension field: pension funds, PAYG (pay as you go) pension institutions, fund managers, benefits consultants, financial institutions and multinational corporations with a particular interest in pension portability.

Whereas the issue of pension portability has several dimensions, the Task Force decided to focus in particular on the cost of and the scope for eliminating obstacles to cross-frontier mobility and to formulate recommendations in this respect.

We see several benefits accruing from increasing the portability of pensions and minimising portability losses in general:

- Increased portability will facilitate labour mobility both within and between member states. The free movement of workers within the single market is a fundamental right and we encourage the Commission to continue to press for the elimination of all measures of discrimination between sedentary and mobile workers within the various pension regimes.
- Increased portability and, ultimately, the possibility of creating a pan-European pension fund for all staff members will lead to a reduction of administrative costs of the increasing number of firms undertaking cross-frontier production and distribution in an integrated approach.
- Revenues from occupational pension schemes are likely to improve as a result of increased competition and product development among scheme providers. With a better performance of second-pillar schemes, the pressure on first-pillar schemes will be alleviated. This is particularly welcome in view of the increasing pressure on first-pillar schemes as a result of the ageing of the European population over the coming decades.
- Minimising portability losses for employees without necessarily interfering with the basic nature of the pensions schemes (which for many firms remain an essential feature of the management of human resources) will also contribute to a reduction of costs and an increase in the scope for enhancing flexibility in the labour market.[1]

Recommendations

In the course of its four meetings, the Task Force discussed a number of issues in the field of pension portability, including general portability issues, the role of taxation, methods of calculation of the actuarial value of pension claims and the relationship between pension portability and labour mobility.

We see a number of ways to improve cross-border portability of pension rights within the EU's internal market:

- Improvement of the scope for transferring the capitalised value of pension rights between pension schemes;
- Coordination of, and increasing transparency in, actuarial calculation of the pension liability (claim);
- Mutual recognition of prudential surveillance of pension funds;
- Elimination of national restrictions on the cross-border membership of pension schemes;
- Elimination of restrictions on deductibility of premiums paid to pension schemes in other EU member states; and
- General shift to the EET (Exemption of contributions, Exemption of pension fund income and Taxation of retirements) principle of taxation of pension provision.

[1] Increasing pension portability for example by reducing vesting periods may of course result in some increase in labour costs in the short term.

Best practice

We recommend that EU member states, preferably within a procedure of "open consultation" (see below), seek to agree on guidelines for "best practice" with respect to:

- vesting of pension rights;
- degree of backloading;
- procedures for adjusting vested pension claims for general inflation; and
- approach to adjusting open-ended pension schemes for changes in life expectancy (as already introduced at least in one member state) and general approach to the actuarial standards for calculating the liability of pension schemes vis-à-vis their members.

The following section highlights those cross-border issues that we take as being of special importance for the approach to pension portability at the European level.

Regulatory issues

The framework for prudential regulation outlined in the draft Directive for a European Institution for Occupational Retirement Provision (IORP) is, as should be expected, exclusively based on the principle of home country rule coupled with bilateral cooperation between member states to sort out cross-border issues. This may be appropriate during the first period of "running in" of the framework but it will be insufficient in the longer run. In the long term the EU should, in our view, envisage the creation of a formalised institutionalised framework for cooperation between national supervisory authorities.[2] In the intermediate phase, consideration should be given to creating a Conference of Pension Fund Supervisors along the lines of the framework for cooperation existing in the field of insurance. An alternative would be to create a special working group under the Conference of Supervisors of Life Insurance. The agenda of this Conference/Working Group should include the following items:

- Vesting of pensions rights;
- Methods of adjustment of vested pension claims;
- Methods of assessment of bio-metric risks, including the assessment of life expectancy during the coming decades;
- Exchange of information on procedures for providing information to members;
- Exchange of information on methods of surveillance of pension fund investment;
- Guidelines for funding of technical provisions and own funds;
- Actuarial standards for calculating the capitalised value of pension claims;
- Rules for transferring vested pension rights from one pension scheme to another (within and between member states);

[2] For a general presentation of the current issues in the supervision of financial services within the EU, we refer to Karel Lannoo, *Supervising the European Financial System*, CEPS Policy Brief No. 21, Centre for European Policy Studies, Brussels, May 2002.

- Rules for prudential surveillance of a European Institution for Occupational Retirement Provision (EIORP); and
- Agreement of the definition of "best practice" towards which member states (old and new) should aim to converge.

Cross-border tax issues

The Task Force fully supports the view of the Commission concerning the need to eliminate all tax-induced obstacles to the cross-border provision of pension services and welcomes the recent judgement of the European Court of Justice on the Danner case. The Commission should make full use of its competence and responsibilities in relation to the effective implementation of single market principles in this area and step up pressure on member states to formulate a viable solution to the remaining issues in this field.

The Task Force recommends the general adoption of the EET principle as the basis for the taxation of pension schemes within the EU.

A pan-European pension fund

The Task Force considers that the creation of a European Institution for Occupational Retirement Provision (EIORP) as proposed by the European Federation for Retirement Provision (EFRP) and endorsed by the Commission would constitute an important step towards the integration of the internal market in the field of pension provision.

We regret that this idea, so far, does not seem to have retained the attention of the Council but invite member states to take steps to explore further the scope for undertaking a pilot scheme, as initially suggested by the EFRP.

The consultation of the social partners

The Task Force is not concerned by the procedure for consultation of the social partners initiated in June 2002, according to Art. 138 of the Treaty.

Nevertheless, we take the opportunity to volunteer a response to the questions put forward by the Commission, as follows.

As indicated above, the Task Force recommends an early creation of a "Conference of Pension Fund Supervisors" within the framework of the implementation of the Directive on IORPs. Whereas in general the cooperative arrangements within financial services cover only elementary rules of prudential surveillance, this Conference should also, in its agenda, include the rules for acquisition, preservation and transferability of supplementary pensions. We would advise against creating a parallel advisory body or "open cooperation" specifically addressing these aspects of pension schemes. We think it is preferable to cover all aspects of the portability of pensions and sustainability of pension schemes within the same framework.

In the opinion of the Task Force, the issue of pension portability should be extensively discussed with the social partners. However, we doubt whether action at the European level could and should be taken in the form of collective agreement. Furthermore, we doubt whether the adoption of a Directive concerning all aspects of the acquisition, preservation and transferability of pension rights would be possible and desirable in the

present context. We therefore prefer the elaboration of codes of best practice and guidelines. The latter could, as indicated above, be elaborated within the framework of a "Conference of Pension Fund Supervisors". We would nevertheless invite the Commission to issue a general recommendation concerning the shortening of vesting periods in all defined-benefit schemes.

As implicit in the answer to the preceding question, we consider that the portability of pensions and the prudential surveillance of pension schemes are matters still largely subject to the principle of "subsidiarity". We would, however, recommend that the social partners would be associated (possibly in special working groups) with the work of the Conference if it were to be created as proposed above.

We would recommend taking whatever action is envisaged at a global (cross-sectoral) level.

We would have a preference for extending the procedures to all occupational pension schemes covered by the IORP Directive. This would include both schemes sponsored by an individual employer and those sponsored by a branch of industry. Whether or not a distinction should be made between pension entitlements based on individual employment contracts and those based on collective agreement is a matter on which the Task Force cannot judge. We would stress, nevertheless, that in the longer run we would expect an increase in the scope for the individual worker to select a pension provider in accordance with his lifestyle and career prospects.

Increasing flexibility and individual choice

We would therefore, more generally, recommend increasing the flexibility in the provision of pension services, including (as is already the case in certain member states) opting out of a general pension scheme for a firm or a branch in favour of individual savings or pension schemes. This would imply offering better possibilities than is now the case of passing from second-to-third pillar schemes.

Future action in the field of pension portability should therefore also examine ways of increasing the scope for enhancing individual choice of retirement provision, as accompanied by adequate and extended rules of deductibility of contributions to all such schemes. This is clearly not in the field of competence of the European Community but as a common issue it should be considered through a procedure of open coordination.

CROSS-BORDER PORTABILITY OF PENSION RIGHTS: AN IMPORTANT CONDITION FOR AN INTEGRATED MARKET FOR PENSION PROVISION

REPORT OF A CEPS TASK FORCE

1 The background

Incompatibility of, and indeed conflicts between, pension schemes in the different EU member states is a major headache for human resource managers of the corporations operating in Europe. Employees who work in one EU country are not allowed to deduct from their taxable income contributions made to a pension scheme in another country. Furthermore, the basic rules for the deduction of contributions and the taxation of pension fund income and of retirement income are not the same in all countries.[3] Highly mobile employees may, therefore, face a bewildering complex of acquired (or pending) pension rights or, worse, the loss of pension rights due to a move before the end of the vesting period, etc. Many multinationals, consequently, have invented internal mechanisms for compensating the welfare loss due to the complexity of the pension schemes for highly mobile employees. The same complexity is found, but in less visible manner, in the case of mobile professionals and independents.

The lack of *pension portability*[4] is a source of additional costs for European enterprises, both directly and indirectly through loss of competitiveness and inefficient allocation of resources:

- Many multinationals are, as indicated, obliged to invent internal mechanisms to compensate employees previously benefiting from occupational (employment-related) pension schemes but who have lost their pension rights due to cross-frontier movements within the firm.
- Individuals moving to another EU country before full vesting of pension rights in an occupational pension scheme or "backloading" of vesting (see glossary) frequently are obliged to choose between two evils: leave the pension scheme in their country of origin or maintain this membership without being allowed to deduct the premiums from their taxable income in the country of residence.
- Lack of pension portability may induce multinational firms to abstain from moving employees to another EU member state or individuals to abstain from taking up residence in another country (and to change job within the country).
- In most EU member states, tax deductibility of premiums paid to pension schemes (including individual savings schemes) is allowed only if those premiums are paid to a pension scheme or insurance company located in the country. This segmentation of the pension markets (coming in addition to restrictions on the investment policy

[3] Not all countries apply the EET rule (Exemption of contributions, Exemption of pension fund income, Taxation of retirement benefits).

[4] For a precise definition of pension portability (and transferability), see the Glossary at the end of this report.

of pension funds) results in considerable hidden economic costs due to inefficient allocation of resources and fragmentation of the pension market.

With the specific aim of analysing and making recommendations with respect to pension portability, CEPS took the initiative in 2001 to convene a "Task Force" inviting participation from all the major players in the pension field: pension funds, PAYG pension institutions, fund managers, benefits consultants, financial institutions and multinational corporations with a particular interest in pension portability.

Whereas the issue of pension portability has several dimensions, the Task Force decided to focus in particular on the cost of and the scope for eliminating obstacles to cross-frontier mobility and to formulate recommendations in this respect.

2 Pension portability and the Single Market "freedoms"

From the point of view of EU law and regulation, the application of the Treaty's provisions on free provision of services, free movement of workers and free movement of capital is of great importance for the future of pension portability.

The 1992 programme of completion of the Community's internal market identified a large number of obstacles to be removed in the field of financial services. Indeed, a study of the potential benefits of the 1992 programme suggested that the benefits of moving towards full integration of financial services would constitute a significant part of the overall economic benefits of this venture. Since 1985, when implementation of the 1992 programme commenced, the EU's financial sector has, indeed, undergone an almost continuous wave of de- or re-regulation.

The 1992 programme, based on the principle of minimal harmonisation and mutual recognition of home-country control, has encouraged integration in the banking, insurance and securities markets. Nevertheless, notably as seen against the background of the parallel implementation of the Economic and Monetary Union, the creation of the European Central Bank and the shift to the euro, further steps were considered needed to create a fully integrated financial market. A Financial Services Action Plan (FSAP) was released by the Commission in 1999[5] with the purpose of providing a basis for a future work programme building on agreed aims as developed in discussions within a working group consisting of personal representatives of ECOFIN Ministers and the European Central Bank (the FSPG) and in the European Parliament. The action plan envisaged the preparation of measures in a number of fields in wholesale and retail financial markets within a framework extending until 2005. One of the stated objectives was to create a single market framework for supplementary pension funds.

As stated in this Action Plan (pp. 7-8):

> It is the competence of the member states to organise pension provision in the light of national circumstances and requirements. However, where they exist, supplementary pension funds (employment related) should be able to operate in a coherent single market framework. The establishment of such a framework was regarded as such a priority by FSPG members that it

[5] European Commission, *Financial Services: Implementing the Framework for Financial Markets: Action Plan*, COM(1999) 232, 11 May 1999.

> warranted a specific debate. This debate centred on the extent to which an appropriate prudential framework for such financial services can enable fund managers to improve fund performance without in any way compromising the protection of fund members. With the introduction of the euro, the use of currency-matching rules and stringent asset-category rules can increasingly – though not exclusively – be replaced by qualitative prudential rules. In this way pension funds can be permitted to select assets that better match the real, long-term nature of their liabilities and thus reduce risk. In order to facilitate the development of funded schemes, a rigorous prudential framework is needed in order to ensure the security of pension fund beneficiaries.

As will be shown below, a draft directive on the prudential surveillance of pension schemes was put forward in 2000 and, not without difficulty, a common position was reached by the Council in November 2002. Furthermore, in the spring of 2002, there were signs that one of the most important obstacles to the free provision of pension services within the single market – the deductibility from taxable income of contributions to pension schemes in other EU member countries – might be closer to removal than at any time since the inception of the 1992 programme.

The Treaty provisions concerning free movement of workers are, however, also of increasing relevance for the portability of pension rights. Indeed, the lack of portability of pensions is considered to be one of the greatest obstacles to the full application of the Treaty articles in this field.

As stated in the Final Report from the High Level Task Force on Skills and Mobility published in December 2001:

> The freedom of movement for persons is one of the founding principles of the European Union, going hand in hand with the promotion of economic and social progress, a high level of employment and achieving balanced and sustainable development. It is indissociable from the creation of an area without internal frontiers, and the strengthening of economic and social cohesion and active citizenship.[6]

The High-Level Task Force Report underlined that greater labour force mobility, both between jobs (occupational mobility) and within and between countries (geographical mobility), will contribute to meeting all of these objectives, by enabling the European economy, employment and labour force to adapt to changing circumstances more smoothly and efficiently, and to drive change in a competitive global economy.

It stressed that a greater degree of mobility between member states will also foster closer political integration in the EU. However, it also underlined that occupational and geographical mobility are not a panacea and that they do not come about by themselves. This is a two-way process: while mobility enhances labour market functioning and thereby contributes to growth and wealth creation, more and better jobs must be created and be available in order to make occupational and geographical mobility a reality.

[6] High-Level Task Force on Skills and Mobility, Final Report, 14 December 2001, p. 6.

It is also important to keep in mind that migration may be motivated by a search for a better climate, lower cost of living or, as is frequently the case, may constitute a return to the region or country of origin after shorter or longer spells of employment in other regions or countries. Thus an increasing number of retired citizens from northern or central Europe settle in the sun belt in Spain, Portugal, Italy, Greece or the south of France.

Migration may also, again increasingly, be a temporary movement in order to accomplish a spell of education in another EU member state or, not least, the United States. Thus within the EU a rising number of students take advantage of the different programmes for exchange and mobility of students (Socrates, Erasmus, Leonardo da Vinci, Marie Curie fellowships, etc.).

3 Obstacles to and costs and benefits of pension portability

As indicated above, the Task Force has concentrated in its discussions and recommendations mainly on cross-frontier portability of pension rights. However, cross-frontier portability is one aspect of the general portability of pension rights whether within or across frontiers. Furthermore, the provisions of the EC Treaty more generally prohibit any discrimination between nationals and non-nationals in domestic policy measures concerning both firms and individuals. Consequently, it is appropriate to examine all obstacles to pension portability with a view to assessing also whether they involve any discrimination of this kind. In fact, as will be shown below, such discrimination is in particular found in the field of taxation and provision of pension services.

The following section briefly examines the main general obstacles to portability while the specific obstacles to cross-frontier portability are considered under a particular heading further below.

3.1 General portability issues

In terms of introductory remarks, it should be stressed that enhancement of the freedom of movement of labour and the free provision of services are not necessarily without costs to society. If it were possible to achieve portability just through an administrative act, it would not be a concern to workers, employers and governments. Furthermore pension portability should not be considered as a target in its own right, but as a means to achieve a more efficient allocation of resources through increased mobility of the labour force and an integrated market for pension provisions. The costs of enhanced pension portability may be a lowering of the incentives of firms to invest in occupational training and other aspects of human capital formation.

Enhancement of pension portability implies adjustment of pension formulas that were initially designed to lock in the workers through incentives to stay. In particular, this means an interpretation of the second pillar more in terms of a less costly vehicle to promote savings for retirement (with respect to individual savings, unrelated to the job) than of an implicit insurance contract, which also partially insures the human capital of the worker.

It must also be recognised, however, that in the modern economy, marked by structural changes and the emergence of the "knowledge society", human resources are no longer

attached to the same extent as they were in the past to one single firm. In most developed economies in a single year, 10% or more of jobs change occupant. Employees therefore increasingly view pensions as deferred pay which even short-tenure workers have a right to accrue, accumulate and bring along during their active life. The trade-off between stability and flexibility may therefore gradually have shifted in favour of the latter aspect of market performance.

Vesting of pension rights

Only few pension schemes offer an immediate and direct right to a pension immediately after joining the scheme. In most cases the pension right is *vested* (acquired by the employee) only after a certain vesting period. In certain older-generation and even existing pension schemes, vesting might actually only take place when the person reached the effective pension age. Nowadays, however, vesting is normally acquired after a maximum of 5-10 years and in an increasing number of (defined-contribution) schemes, after only a short or no vesting period.

Employer-sponsored pension schemes became part and parcel of many employment contracts in the 19th century used by manufacturing firms to charitably retire older workers whose productivity was waning. In most cases employment was considered a lifetime engagement and firms frequently did not, for obvious reasons, provide pensions to workers leaving before retirement.[7]

Delayed vesting and backloading (on backloading, see the following section) of pension rights were no doubt initially designed in order to enhance labour productivity and/or reduce labour costs and provide incentives for in-house training by encouraging a long-term relationship between workers and employers.

Under this perspective, the pension promise contained insurance features (particularly in the DB formula) not easily accessible to the single worker in the market. It is a widespread opinion, and possibly an empirical fact, that in the modern economy, where flexibility of the labour market is privileged and where the insurance markets are more complete and less imperfect than in the past, this imposes undue costs to the firms, particularly to multinational companies, or to the mobile workers.

Nevertheless, until recently, vesting of pension rights in supplementary pension schemes has not been a major concern in the EU. In fact, in the vast majority of EU countries, retirement benefits have been ensured mainly through general public or quasi-public (statutory) pension pay-as-you-go (PAYG) schemes. In many of these schemes, vesting takes place only after a certain number of years of membership. In these schemes, however, pension rights are not normally associated with employment in a specific firm. Even highly mobile employees may consequently accumulate pension rights during the whole active life. Moreover, even if the individual loses contributions, (s)he may participate in the general welfare schemes provided by the state.

Given the prospects of a substantial increase in the old-age dependency ratio (the ratio of retired persons to the number of persons in the active age groups) during the coming decades, the public PAYG schemes are expected to become subject to increasing

[7] John Turner, *Pension Portability in the United States*, Public Policy Institute, American Association of Retired Persons (AARP), June 2002, p. 3.

problems of sustainability. One of the consequences of this development may therefore be a gradual lowering of the level of replacement income provided by these schemes. In order to ensure an "appropriate" overall level of income after retirement, many countries therefore envisage the introduction of (or expansion of) supplementary employment-related pension schemes or, alternatively, of private annuity schemes providing supplementary income after retirement.

In view of the prospective increase in the relative importance of these supplementary schemes, the mechanisms for vesting of pension rights in such schemes in many EU member states are therefore likely to become a more topical policy issue than was the case in the past.

According to a survey undertaken by the "Advisory Group",[8] only four European countries with occupational pension schemes have a statutory requirement of immediate vesting and in certain countries, vesting may be provided on a discretionary basis. In other countries vesting takes place only after a certain period. Furthermore, between 1998 (the year of the last Survey by the Group) and 2001, a number of countries, including Italy, Norway and Sweden, have reduced the number of years of service to be completed in order to qualify for vesting rights. In Germany, where vesting normally was only granted after ten years, a reduction to five years has been approved in 2001.

Defined-benefit schemes still constitute a majority of supplementary pension schemes in most EU member states. During the last two decades, however, an increasing share of the pensions market has been taken by schemes providing a pension determined only by the contributions paid into the fund and by expected longevity, independently of the level of compensation and/or the duration of contributions and membership. In the United States such plans (defined-contribution schemes) now cover more than two-thirds of workers participating in pension schemes as against less than one-half some 20 years ago. Defined-contribution schemes are common among small employers in the UK, and there are a number of quasi-DC plans in Sweden. In Ireland and France, many (voluntary) second pillar plans are also on a defined-contribution basis and such plans are gaining importance in other EU member states such as Belgium, Denmark and Italy (new pension system). They are still rare or non-existent in other member states such as, notably, Germany and the Netherlands.

Backloading of pension benefits

In many employer-sponsored defined-benefit plans (but also in a number of first-pillar PAYG schemes), the pension benefits for a person having worked the number of years required to acquire full pension rights are determined in proportion to the worker's average earnings during a certain period before retirement. In certain schemes the pension benefit may be a proportion of the earnings during the last year of activity, a certain number of years before retirement or, alternatively, the "best" years during active life. These aspects of the pension schemes (backloading) may result in lower pension benefits for mobile than for sedentary workers.

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[8] Groupe Consultatif des Associations d'Actuaires des Pays des Communautés Européennes, *Actuarial Standards for Transfers between Pension Schemes in the Countries of the EC and other European Countries,* Survey, June 2001.

If a worker quits the firm even after having attained the minimum conditions for vesting in a defined-benefit scheme, the accrued pension benefits will be determined by:

- rules for calculation of the benefits,
- existence of premiums for long tenure and
- rules for indexation of the benefits.

Regarding the rules for calculation of the benefits, certain schemes may in the past have offered a stepwise increase in benefits in proportion to the earned income (backloading). As an illustration, benefits may accrue at the rate of, say, 1.5% of compensation per year for the first five years of employment, 1.75% of compensation for the next five years and 2% for all additional years. Such progressive calculation of benefits is now much less common than in the past.

An additional source of backloading may exist as a result of premiums for long tenure, such as, for example, a particular accumulation of pension rights after the attainment of the age of 60. Even the rules for taking early retirement may actually involve a certain degree of backloading since early retirement will frequently be granted only to workers with a certain minimum tenure in the same firm. This may be one of the most important costs of changing jobs and thus to pension portability.

Although most DB schemes thus involve a certain degree of backloading, there are also examples where defined-benefit schemes actually entail a degressive accrual of benefits (front-loading). Front-loading may, for example, occur in schemes involving a maximum number of years to count for benefits. Front-loaded schemes may thus contain incentives to early retirement or shifting to another job before statutory retirement age.

The most important source of backloading of pension rights may, however, in many schemes, be the rules for adjustment of the accrued pension benefits in response to the rise in prices and/or wages. In most defined-benefit schemes, the benefits for a full tenure are calculated as a proportion to the final salary or some other reference salary. In the case of mobile workers, schemes may offer some degree of indexation of accrued benefits to the subsequent increase in prices, but the indexation may be only partial and the final replacement income may consequently be considerably lower than for an employee who stayed with the same employer for the full active life.

A key issue in pension theory and pension analysis is therefore whether mobile workers tend to be compensated for this loss of pension rights through a higher level of current wages. Comparative studies of the wages of stable versus mobile workers, however, have shown the former to have higher current earnings in addition to have a higher level of pensions. Consequently, pension schemes may actually still be one of the ways to compensate (and retain) workers with a high productivity.

Obstacles due to conflicts of tax systems

Long vesting of pension rights and backloading of pension benefits are important obstacles to portability and consequently a source of certain rigidities in the functioning of labour markets. However, these sources of labour market rigidity normally (that is, with a few exceptions, notably concerning the transfer of lump sum payments) do not involve discrimination between nationals and non-nationals or between residents and

non-residents. Vesting of pension rights and backloading of pension benefits, consequently, do not in general cause restrictions on cross-border mobility of labour and are therefore not in the area of competence for EU legislation.

The functioning of tax systems, on the contrary, frequently results in discrimination between residents and non-residents and/or between domestic and foreign pension providers. Consequently, the functioning of tax systems may create obstacles to cross-border movements and therefore become a matter of EU competence. The functioning of tax regimes, the direction of EU jurisprudence and various initiatives to eliminate tax-induced obstacles to cross-border mobility are therefore dealt with in more detail below in a special section on cross-border portability.

3.2 Means of ensuring portability

Transferring cash balances

In most countries, employment-related pension schemes provide a right to a nominal benefit, determined as a proportion of the compensation earned by the employee during a reference period (defined-benefit scheme). In such schemes, a part of the contributions are frequently paid by the employer and the remainder by the employee. If the employee leaves before full vesting, his/her contributions may in some cases be capitalised and used for purchasing rights in another scheme or paid out as a cash benefit. Even after full vesting, certain defined-benefit schemes may actually offer the option of conversion (capitalisation) of the pension right allowing the employee to transfer the capital to (purchasing pension rights in) another employer-sponsored pension scheme. However, the specific rules of taxation concerning these transactions and the method of determining the value to transfer and the credit granted in the new scheme (see below) will be decisive for determining the costs and benefits of changing pension scheme. Furthermore, the cash balance may be adjusted by applying an interest rate to the "capitalised" contributions. As this balance is only a bookkeeping entry, the value of the cash balance will have no relation with earnings of underlying assets. Depending upon the rate of adjustment of the balance, the mobile employee may suffer portability losses or actually accrue a higher amount than would be the case had he/she stayed in the job.

The final outcome of such a cash balance transfer will depend upon the way in which this amount is utilised to acquire pension rights in another plan or, alternatively, is deposited into an individual savings account. Any transfer of a cash balance or an estimated value of the vested pension right will thus be fully dependent upon the actuarial rules for determining the present (discounted) value of these rights. As will be discussed in the following section, however, rules for estimating the actuarial fair value of pension entitlements are not necessarily consistent between pension schemes and show wide differences from one EU member state to another.

In addition, in certain countries (as illustrated by Denmark and the Netherlands), defined-benefit schemes may actually cover a branch or sector of the economy allowing, thus, changing of employer without leaving the pension scheme.[9]

[9] A comprehensive discussion of these technical aspects of these issues in the United States can be found in John Turner, *Pension Portability in the United States*, Public Policy Institute, AARP, June 2002.

Rules for calculating the value of pension claims

In certain conceptual work on actuarial standards based on the "implicit contract model", estimates of the real value of a worker's pension claim include an estimated current value not only of already accrued pension benefits but also of future benefits accrued until retirement of the worker. In an influential paper published already 20 years ago, Jeremy Bulow argued that corporate pension liabilities in a defined-benefit scheme ought to be estimated taking account only of the already accrued benefits and whatever the worker would receive if the contract were immediately terminated.[10]

The conclusion of Bulow's analysis was, therefore, that the value of pension claims (and the corresponding pension liabilities for the firm) at any point in time should be estimated not on the basis of "projected benefits", but only as the maximum liability the firm would incur in case the plan was terminated – either through dismissal of the worker, closure of the firm or, for example, a decision of the firm to replace a defined-benefit scheme by a defined-contribution scheme.

Thus, accrued benefits, roughly equal to vested benefits, would be the most appropriate measure of the firm's pension liabilities. Vested benefits are not dependent upon subjective actuarial assumptions concerning projected benefits, except for a nominal interest assumption adjusting past contributions to the pension schemes. Following Bulow, pension claims in a defined-benefit scheme can thus (despite the fact that there is not a direct link between contributions paid and vested benefits) be measured in a way that frequently would provide results not far from the accrued value of an individual's pension claims in a defined-contribution scheme.

In fact, the accounting profession, as expressed in the different guidelines for calculating pension liabilities, tends to measure the exposure of a company on the basis of projected benefits, including thus not only accrued but also estimated future pension rights of the employees.

In practice, certain EU countries actually seem to follow rather closely the recommendations put forward by Bulow on the basis of theoretical considerations for the rules for calculating the capitalised value (transfer value) of pension claims. In other countries the actuarial value may be calculated as the mathematical reserve with respect to vested benefits using mortality tables. In most cases the two approaches should give relatively similar results if the contributions to the pension scheme are calculated so as to provide the surrender value for an insurance reserve covering the accrued (vested) pension claim.[11]

Thus, according to the Survey undertaken by the "Groupe Consultatif" (see above), in Austria, Belgium, Denmark, Ireland, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom, the calculation of the transfer value of pension claims is based on an adjusted value of premiums paid or the actuarial value of vested benefits. In the

[10] Jeremy I. Bulow, "What are corporate pension liabilities?", *The Quarterly Journal of Economics*, August 1982.

[11] Since a DB plan is financed typically by determining a contribution for the plan as a whole, such a scheme may involve a certain degree of cross-substitution or sharing of risk. Consequently the value that one individual may obtain from the scheme may be very different from that of another person with the same contribution history but with, for example, a different life expectancy.

Netherlands where occupational defined-benefit schemes are widely in use and have been so for a long time, the calculation of the transfer value is based on prescribed rules. In this country, the present value of vested benefits is calculated using a discount rate of 4% per annum. In the other countries in this group, the value is calculated by the actuary of the pension scheme using "standard" assumptions. In Ireland and the United Kingdom, the actuary is required to follow professional guidance notes. In Italy transfer from the DC schemes is possible. In Germany there is no legal obligation to allow transfer but transfer can take place with an agreement of all parties, with the transfer value being subject to agreement between the old and new employer. In Finland transfers from DB plans are not possible, while in France benefits from the DB plans are not vested until retirement and are therefore not subject to any transfer arrangements.

Following the Groupe Consultatif, the treatment of the transfer payment in the receiving plan shows considerable variations. For transfers to a defined-contribution plan, the amount received is treated as a special contribution to the plan and this approach is also used in some countries even where the main benefits provided under the receiving plan are on a defined-benefit basis. Where defined benefits are provided for a transfer payment received (added years of service), these are usually calculated as the actuarial equivalent of the amount received.

4 Cross-frontier portability of pension rights

Within EU member states the portability of occupational pension schemes has rarely been perceived as a policy issue. In fact, as already indicated above, occupational pension schemes still account on average in the EU for only about 10% of pension benefits. Only in the United Kingdom, Sweden, Ireland and the Netherlands are such pension schemes an important feature of the pension systems. In these countries, the determination of vesting periods, indexation of pension rights and pension portability have already in the past been subject to debate. In the Netherlands, participation in occupational pension schemes is, after negotiation among the social partners, made mandatory. In Denmark participation is also mandatory for a number of professions. The same applies in Sweden and also Belgium, with a recent draft bill, is following this direction. In other countries the provisions of those schemes are in general considered to be a matter to be decided at the level of the firm or the profession and the authorities have on the whole only intervened to ensure appropriate prudential supervision so as to guarantee that the assets of the pension scheme are sufficient to cover the liabilities vis-à-vis the members. With a few exceptions, EU member states have therefore not taken policy measures to shorten vesting periods or reduce other obstacles to portability.

However, results from the national strategy reports submitted by member states in the framework of the open method of coordination in the field of pensions, have, or are about to do so, reduced vesting conditions and obstacles to portability of supplementary pension rights, whenever it was deemed necessary (e.g. Germany, Spain, Portugal, etc). However, it must once again be stressed that the rules and regulations governing the occupational pension schemes are wholly in the realm of national competence and therefore not a concern for the EU.

Nevertheless, the EU Treaty, as indicated above, prohibits any kind of discrimination between EC nationals due to citizenship and provides for the "four freedoms". Workers

moving from one EU member state to another may in various ways be prevented from fully benefiting from these four freedoms. Consequently the EU will be entitled to intervene in order to ensure that national rules and regulation are applied in such a way as not to discriminate against such mobile workers. In addition, the Treaty directly provides for free provision of services, and the EU will be entitled to intervene in order to ensure that firms in one country are allowed to provide services in another country as long as the common (minimum) prudential rules are respected.

Since the (national) application of rules and regulation and taxation of pension schemes may involve various kinds of discrimination against mobile workers or include obstacles to the free provision of services, all these aspects may be examined in order to assess whether their (national) application actually involves any such discrimination. Whereas the application of vesting or backloading in general will not involve discrimination, the provisions for cross-frontier transfer of the capitalised value of pension rights and the deductibility of premiums to pension schemes in another member state may frequently result in discriminations. A long-standing issue in EU jurisprudence has therefore been whether such discrimination can nevertheless be justified by other provisions or general interpretation of the Treaty.

4.1 Cross-border transfer of the capitalised value of pension rights

In a number of EU member states, cross-border transfer between pension schemes[12] is theoretically possible, although there may be major difficulties in actually implementing the acquisition of pension rights in a new foreign plan. In Austria, Belgium, Germany, Ireland, Luxembourg, the Netherlands, Portugal and the United Kingdom, transfer is possible but may be subject to certain prudential criteria and to rules concerning the settlement of tax liability. In the Netherlands, however, transfer must be approved by the insurance supervisors and will require their acceptance concerning the prudential standards of the receiving pension plan. In Spain where transfer is possible to "qualified pension schemes", foreign plans would not be treated as "qualified" and cross-border transfer consequently is excluded. In Finland, France and Sweden, the cross-border transfer of pension capital is not allowed and in Denmark, only with a very high (prohibitive?) tax liability on the transfer.

4.2 Cross-border membership of pension schemes

As shown in the preceding section, cross-border transfers of pension rights even in the rare cases where it is theoretically possible will frequently run into a number of obstacles such as, notably, settlement of tax liabilities or restrictions due to lack of mutual recognition of prudential rules concerning pension schemes. Workers moving from one EU member state to another may therefore frequently – in order to safeguard the future pension benefits – opt for continuation in the pension scheme of the country

[12] By cross-border transfer of pension rights is here understood the purchasing into a foreign pension schemes and an associated acquisition of pension rights. A number of pension schemes offer the possibility of offering a lump sum payment to a member upon leaving the pension scheme. The transfer to another member state is an ordinary capital transaction covered by the freedom of capital movement. The beneficiary would of course be totally free to purchase, for example, a life insurance or an annuity in another country. Such a transaction is clearly outside the scope of the present Report and does not lie within the realm of pension portability issues.

of origin or, alternatively, purchase pension rights in, and pursue contributions into, another scheme in the latter country.

Whereas this solution will normally be feasible, most EU member states will, however, not allow the worker to deduct contributions to a pension scheme in another member state from the taxable income in the country of residence. In practice, therefore, the costs of taking up or continuing a pension scheme outside the country of residence have up to now been so high that this solution is normally only applied in multinational firms with highly mobile blue- or white-collar staff and only for short periods.

Recently, however, the scope for eliminating taxation-induced obstacles to cross-frontier portability of pensions has been considerably enhanced through an important evolution of the Community's jurisprudence. The following section will therefore examine in some detail the evolution of the EU jurisprudence in this respect.

5 Community legal issues and jurisprudence

5.1 The Bachmann case

The efforts to do away with tax-induced obstacles to free provision of services within the single market received a major blow in 1992, due to a decision by the Court of Justice of the European Communities in the famous case: Bachmann v Belgian tax authorities.[13] In fact, like a number of other member countries, Belgium allows its taxpayers, within limits, to deduct certain sickness and invalidity contributions, and certain life insurance contributions from their taxable income. This includes contributions paid to an individual pension plan as well as contributions, by the employer and the employee, to a group pension plan.

Deductibility of these contributions was, in 1975, (with some nuances) made subject to the condition that they be paid to an insurance company established in Belgium (i.e. a Belgian-incorporated insurance company or a Belgian branch of a foreign insurance company). In the 1970s, Mr Bachmann, a German national, took up residence in Belgium. Before moving to Belgium he had taken up an individual life insurance policy and a sickness and invalidity policy with two German insurance companies. After having moved to Belgium, Mr Bachmann continued payment of his contributions to the two German insurance companies and deducted these premiums from his taxable income in Belgium as he would have been allowed to do had he paid the premiums to insurance companies located in Belgium. Despite the fact that such deductions were allowed (on the basis of reciprocity) for French, Dutch or Luxembourg nationals working in Belgium, the Belgian tax authorities rejected Mr Bachmann's request.

The case eventually came before the Belgian Supreme Court which in turn asked the Court of Justice of the EC whether the Belgian tax regulation at issue could be viewed as being:

- a restriction on the free movement of workers (Art. 48 of the Treaty); and/or

[13] The following paragraphs draw extensively upon, Marc Dassesse, "The Bachmann Case: A Major Setback for the Single Market in Financial Services", *Butterworths Journal of International Banking and Finance Law*, June 1992.

- a restriction on the free provision of services by foreign insurers in Belgium (Art. 59 of the Treaty); and/or
- a restriction on the free movement of capital and payments in the Community (Arts. 67 and 106 of the Treaty).

The Court of Justice concluded that *Articles 48 and 59 of the Treaty*[14] *indeed precluded the legislation of a member state from subjecting the deductibility of sickness and invalidity insurance contributions or pension and life insurance contributions to the condition that the contributions are paid in that state.* However, the Court went beyond the opinion of its Advocate General and concluded that *such a condition is permissible if it is necessary in order to ensure the cohesion of the relevant fiscal system.*

The Court thus at that stage took the view that when Belgium allows the deduction of a life insurance premium from taxable income, it must be able, at some later stage, to levy the tax due on the sums paid by the insurer pursuant to the insurance policy.

The Court recognised that double-tax treaties between certain member states allowed the deduction of insurance contributions paid to an insurer in another contracting state and gave to one contracting state the sole right to tax the sums paid by the insurers pursuant to their contracts. According to the Court, such a result can only be reached by the conclusion of such treaties or by adoption of the necessary coordination or harmonisation measures.

5.2 The position of the European Commission

The European Commission already at the time of the Bachmann case and in parallel brought an action for a declaration that "by making the deductibility from taxable income of supplementary pension or life assurance contributions conditional on those contributions being paid to an undertaking established in Belgium or to the Belgian establishment of a foreign insurance undertaking, the Kingdom of Belgium has failed to fulfil its obligations under Arts. 48 and 59 of the Treaty".[15] The Court, as could be expected, dismissed this application. As in the Bachmann case, it also stated that (with reference to an earlier judgement in case 205/84, Commission v Germany) the conditions for tax deductibility were "indispensable to the achievement of the public interest pursued" and that consequently the contested provisions were not contrary to Art. 59 of the Treaty.

In its 1997 Green Paper on Supplementary Pensions in the Single Market,[16] the Commission stressed that, following another ruling by the Court, fiscal cohesion could not be invoked as a justification in circumstances where a member state had voluntarily given up that coherence, for example in the provisions of a double taxation treaty with another member state. However, it also stressed that when it comes to the taxation of occupational pensions, existing agreements tended almost exclusively to concentrate on eliminating the double taxation of pensions when they are paid. In fact, in this respect, most bilateral treaties follow Art. 18 of the OECD Model Treaty giving the country in

[14] Between the Bachmann and the Danner case the numbering of the Treaty articles has been modified!

[15] Judgment of the Court of 28 January 1992, Case C-300/90.

[16] European Commission, *Green Paper* on *Supplementary Pensions in the Single Market*, COM(97)283, 1997.

which the taxpayer resides the exclusive right to tax pension income from a private employment. This is in contrast to pensions for public services which, according to Art. 19, are generally taxed in the country in which they originate.

Furthermore the Green Paper recalls that a few bilateral agreements between member states, such as the ones between France and the UK and between Denmark and the UK, provide for a form of mutual recognition of tax-approved pension schemes and allow the migrating worker to continue to get tax relief on pension contributions to his former pension scheme in his or her new country of residence.

Referring to an earlier Commission report on the development of tax systems (22/10 1996), the Green Paper stressed the extreme complexity of bilateral double tax treaties, notably in view of a further enlargement. It therefore argued that it might prove most useful to explore ways of improving the coordination and scope at Community level of tax rules relating to pension provision, while recognising that such rules would be subject to unanimous decisions in the Council.

In the wake of the Green Paper, the Commission has taken a number of initiatives addressing the specific cross-border issues in occupational pension schemes. Following a proposal by the Commission, the Council thus in 1998 adopted a Directive on the safeguarding of supplementary pensions, allowing in particular posted workers to remain in their home country supplementary pension scheme. The aim of this Directive was to protect the rights of members of supplementary pension schemes who move temporarily from one member state to another, thereby contributing to the removal of obstacles to the free movement of employed and self-employed persons within the Community (Art. 1).

The measures provided for include:

(i) equality of treatment as regards preservation of vested pension rights for members of a supplementary pension scheme of whom contributions are no longer being made as a consequence of moving from one member state to another;

(ii) freedom of cross-border payments of supplementary pension schemes;

(iii) measures to allow workers posted in another member state to continue to pay contributions to a supplementary pension scheme in the country of employment and to exempt his employer from any obligation to make contributions to a supplementary pension scheme in the country where he/she is posted; and

(iv) an obligation to ensure that employers, trustees or others responsible for the management of supplementary pension schemes provide adequate information to scheme members, when they move to another member state, as to their pension rights and choices available under the scheme.

In accordance with this Directive, member states shall introduce laws, regulations and administrative provisions necessary to comply with this Directive not later than 36 months following the date of its entry into force. Furthermore, member states should not later than 25 January 2002 communicate to the Commission the text of the provisions of national laws that they adopt in the field covered by the Directive.

The Commission's assessment of the tax issues was expressed in detail in a communication in April 2001.[17] In this Communication, the Commission again argued that national rules denying equal treatment to pension schemes operated by pension institutions established in other member states are in breach of the Treaty. The Commission would in this respect monitor member states' national rules and take the necessary steps to bring effective compliance with the fundamental freedoms of the EC Treaty, including bringing the matter before the European Court of Justice.

The Commission furthermore pointed out that an appropriate framework for exchange of information concerning the income and status of residents existed in the form of the 1977 Mutual Assistance Directive. In the Commission's view, a member state could not refuse to provide information to another member state simply on the ground that this information was not needed for domestic tax purposes. Consequently, an adequate system of information exchange could be put in place in the area of taxation of pensions.

The Commission also expressed support for the proposal for Pan-European Pension Institutions put forward by the European Federation for Retirement Provision (see below) and, finally, invited member states to explore the possibility of adopting the EET principle[18] as the broad basis for taxation of pension schemes in the EU.

The conclusions of this Communication state that:

> The Commission considers that discriminatory tax treatment of pension and life assurance policies concluded with pension institutions established in other member states is contrary to the fundamental freedoms of the EC Treaty. The Commission shall monitor the relevant national rules and take the necessary steps to ensure effective compliance with the fundamental freedoms of the EC Treaty, including bringing the matter before the Court of Justice on the basis of Article 226 of the EC Treaty.
>
> The Commission invites the Council, the European Parliament and the Economic and Social Committee to:
>
> - examine the proposals made in this Communication on the exchange of information with a view to safeguarding the proper application of member states' tax rules;
> - examine the proposal for pan-European pension institutions as reflected in this Communication;
> - consider broader application of the EET principle within the European Union;
> - and examine the measures necessary to eliminate unjustified obstacles to the free movement of workers resulting from the diversity of member

[17] Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, *The elimination of tax obstacles to the cross-border provision of occupational pensions*, COM(2001) 214 final.

[18] Exemption of taxation of pension contributions, Exemption of taxation of investment income at the level of the pension institutions and Taxation of pension benefits.

states' occupational pension taxation systems, in particular from double taxation.

The Council welcomed this Communication on 16 October 2001, and stressed the importance it attached to improving the exchange of information on occupational pensions as a means of safeguarding member states' tax revenue in a single market with increased cross-border labour mobility. It also endorsed the Commission's proposals to hold consultations in the Committee provided for by the 1977 Directive. Finally it asked the permanent representatives to ensure better coordination of the different co-existing systems for the taxation of occupational pensions by developing arrangements for the elimination of double taxation and double non-taxation in the area of occupational pensions and report to it before the end of 2002.

The Council, on the other hand, remained silent concerning the proposal to explore the scope for pan-European pension institutions, suggesting only weak or no support among member states for this particular idea.

The European Parliament and the Economic and Social Committee have both expressed support for the recommendations put forward in the Commission's communication.

5.3 The Danner case

Mr Rolf Dieter Danner, a doctor of German and Finnish nationality, lived and worked in Germany until 1977 when he moved to Finland. After moving to Finland, Mr Danner continued to pay pension contributions to two German schemes within the framework of, respectively, a compulsory general pension insurance scheme for all employees and a supplementary pension insurance scheme (also compulsory) for all doctors working in the geographical area where it applied (Berlin). According to Mr Danner, whilst he was not legally required to continue these contributions, he had in fact to do so to benefit from pension in case of invalidity.

For 1996 (the tax year at issue), Mr Danner claimed deductions from his taxable income of these contributions plus the contributions to an additional Finnish pension insurance policy contracted that same year. However, the Finnish tax authorities allowed him to deduct only to the extent of 10% of his taxable income, or somewhat more than his contribution to the Finnish scheme but less than half the amount of his pension contributions. Mr Danner's request for a rectification was rejected by a decision of 17 February 1998, following which Mr Danner appealed to the relevant administrative court. On 22 March 2000, this court referred the case to the Court of Justice for a preliminary ruling. As presented in the opinion of the Advocate General Jacobs delivered on 21 March 2002,[19] this appeal concerned (essentially) the application of:

- Article 49 (freedom to provide services)
- Article 56 (free movement of capital)
- Article 12 (prohibition of discrimination on grounds of nationality); and
- Article 87(state aid).

[19] Opinion of Advocate General Jacobs, delivered on 21 March 2002 in Case C-136/00, Rolf Dieter Danner.

The Commission in its submission also suggested that the Court should examine the application of:

- Article 39 (freedom of movement of workers); and
- Article 43 (freedom of establishment).

The Advocate General assumed that the referring court deliberately chose not to refer to these latter provisions but nevertheless proposed to deal only with the provisions expressly mentioned in the order for reference.

Concerning the *need to preserve the coherence of the Finnish tax system*, the Advocate General expressed agreement with Mr Danner, the Commission (and the EFTA Surveillance Authority, which had submitted observations as well) that in view of the design of the Finnish income tax system the Finnish Government could not invoke the need to preserve fiscal coherence. In particular, he underlined that there were no true direct links between the deductibility of contributions and the taxation of the pension benefits and that, in particular, Mr Danner would (in accordance with a double tax treaty between Germany and Finland!) be liable to Finnish income tax on the pensions to be received from the two German pension schemes.

Furthermore, the Advocate General expressed agreement with Mr Danner, the Commission and the EFTA Surveillance Authority that the rules in issue infringe the principle of proportionality.[20] In his view it is possible to attain the legitimate objectives of ensuring the effectiveness of fiscal controls and preventing tax evasion by means considerably less restrictive than a general refusal of deductibility for all contributions to foreign insurance institutions. Indeed, the very fact of allowing deductibility of the contributions to the German pension scheme would be a most valuable source of information concerning the expected benefits to accrue after Mr Danner's retirement.

In sharp contrast to the judgement in the Bachmann case, the Advocate General therefore concluded that:

> Tax law provisions of a member states which restrict or preclude deductibility for income tax purposes of voluntary pension contributions paid to pension providers in other member states, whilst allowing the deductibility of contributions to equivalent voluntary pension schemes operated by pension providers in the first member states, are contrary to Article 49 EC.

The Judgement of the Court largely followed the recommendations expressed in the Opinion of the Advocate General.

The Court, first of all, agreed (like in the Bachman case!) that the Treaty provisions relating to freedom to provide services clearly were applicable to the Danner case, in so far as for purposes of application of the Treaty, the premiums paid to the German pension schemes constituted (advance) payments for the pension services provided by those schemes.

[20] The general principle is that the measures in force to deal with a certain issue must be in just proportion to the issue in question ("don't shoot sparrows with a cannon").

Furthermore, the Court stated that although direct taxation as such falls within the competence of the member states, they must nevertheless exercise that competence in accordance with Community law. In particular, Article 59 of the Treaty precludes the application of any national legislation that has the effect of making the provision of services between member states more difficult than the provision of services within one member state. In the case in point, the denial by the Finnish authorities of the right to deduct premiums to voluntary pension insurance schemes in another member state would be liable to dissuade such pension institutions from offering their services in the Finnish market.

Adopting the same line as that taken by the Belgian authorities in the Bachman case, the Finnish and Danish governments had submitted that the legislation in question could be justified by the need to ensure the cohesion of the Finnish tax system. According to those governments, that system is based on the existence of a direct link between the deductibility of contributions to voluntary pension insurance schemes and the liability to income tax of the pension payable by insurers. The loss of revenue resulting from the deduction of insurance contributions is in principle offset by the taxation of pensions at a later stage. Referring to the Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee on the elimination of tax obstacles to the cross-border provision of occupational pensions (OJ 2001 C 165, p. 4), the two governments maintained that the Finnish taxation system encourages savings and the development of pension plans by providing a tax deferral on the contributions paid, thus making it possible to cope with the ageing of the population by reducing current tax revenues in exchange for higher revenues later.

The Finnish government added that it taxed not only the pensions paid by Finnish and foreign institutions to residents, but also those paid by Finnish institutions to non-residents (taxation at source). Therefore, if contributions were paid to a Finnish insurance company, the pension would be taxed in Finland even if the taxpayer has moved abroad. That was not the case if the taxpayer who leaves the country has paid contributions to a foreign insurance company. The need to preserve the cohesion of the Finnish fiscal system thus, according to the Finnish submission, precluded the deduction of the latter contributions.

The Court did not accept this argument. First of all, it stressed that in the Bachman case, since Mr Bachmann's contributions had not been deducted, the pension benefits received ultimately from the German pension scheme would not be subject to Belgian income tax. In the present case, in contrast, Mr Danner's pension benefits from the German schemes would be subject to Finnish income tax, even if he would be denied tax-deductibility of the contributions to these schemes. In addition, a double-taxation convention in fact has been signed between Finland and Germany and according to the Court, it is then up to the tax authorities to ensure "fiscal cohesion".

Building further on this argument, the Court stressed that the 1977 Directive on exchange of information between fiscal authorities could be relied upon to ensure that the correct amount of income taxes would be paid by taxpayers according to the legislation in force in the country of residence. Furthermore, by having applied for deduction, in the taxable income, of contributions to a foreign pension scheme, the taxpayer has provided the tax authorities with a "valuable source of information about the pensions that will be paid to taxpayers at a later stage".

The Court thus concluded that Article 59 of the Treaty is to be interpreted as precluding a member state's tax legislation from restricting or disallowing the deductibility for income tax purposes of contributions to voluntary pension schemes paid to pension providers in other member states while allowing such contributions to be deducted when they are paid to institutions in the first-mentioned member state, *if that legislation does not at the same time preclude taxation of the pensions paid by the above-mentioned pension providers.*

The Court in fact stressed that by denying deductibility of premiums to the German scheme, the Belgian tax authorities had also abstained from taxing his benefits, while the Finnish tax system would actually result in double taxation. The Court has thus not totally discarded the "cohesion argument" advanced by the Finnish (and Danish) government. It cannot be excluded that national tax authorities might try to imitate the Belgian rules by exempting pension benefits from a foreign scheme from taxation in cases where they have denied tax deductibility of the contributions to that scheme. Such measures would however introduce new elements of complication in the tax schemes and in fact would constitute a new source of discrimination between different categories of taxpayers and a setback for the completion of the single market for pension provision.

The judgement nevertheless constitutes an important additional element in case law (jurisprudence) concerning the interpretation of the Treaty provisions on the free provision of services within the EU's internal market. It can be seen as paving the way towards the setting up of a more efficient system of exchange of information and coordination between tax authorities in the different EU member states. It thus helps to remove one important obstacle to the free provision of pension services within the single market. It must be hoped that member states would rather follow this route and collaborate by enhancing the systems of exchange of information and coordination of tax systems offered within the framework of the 1977 Directive. It is in this respect encouraging that the EcoFin Council on 27 January agreed on an EU-wide savings income tax regime based on a system of automatic exchange of information.

In February 2003, the European Commission initiated action against Denmark, requesting this member state to amend the legislation according to which contributions paid to non-national funds are not tax-deductible in the same way as contributions paid to domestic funds. The European Commission also started the first phase of the infringement procedure against Belgium, Spain, France, Italy and Portugal with a view to eliminating any tax obstacles to the cross-border provision of occupational pension schemes that are contrary to European Community law.

6 Other initiatives in favour of integration of the pension market

6.1 A pan-European pension fund?

As indicated above, the Commission, in its April 2001 Communication on the elimination of tax obstacles to the cross-border provision of occupational pensions, endorsed the proposal put forward in July 2000 by the European Federation for

Retirement Provision (EFRP) concerning the creation of a Pan-European Pension Scheme.[21]

The report prepared by the EFRP argued as follows:

- Pension funds are needed both to ensure an appropriate level of benefits to future pensioners and to contribute to the development of European capital markets.
- European employers want increasingly to look at Europe as a single operating territory and operate on a pan-European basis within the single market.
- Sponsoring employers need increasingly to provide consistent benefits across Europe in line with their reward objectives and business strategy.
- Sponsoring employers are increasingly seeking opportunities for cost reductions by combining their pension liabilities within a single instrument and managing the risk in the pension area most efficiently.

Consequently, the EFRP proposed that an IORP established and regulated in one member state be allowed to establish separate sections that are tax-approved in other member states and that comply with the local social and labour laws.

As the most important obstacles to be overcome, the EFRP cited the following:

- Solvency requirements and other regulatory issues;
- Settlement of tax liabilities;
- Compliance with employment and social law; and
- Governance.

As far as regulation and solvency rules are concerned, there is, as stated in the report, a need for "regulators to understand each other's approach and above all to avoid the imposition of conditions that would hinder the operation of a single market".

With respect to the taxation, the EFRP argues that the main difficulty is how to determine what proportion of the assets of an IORP belong to which section and therefore are subject to the taxation policy of the appropriate member state. It proposes that the assets are divided between each section (country) in accordance with the corresponding liabilities at the last actuarial evaluation and taxed accordingly.

On employment and social law, the EFRP proposes that the employment and social law applicable in each member state would apply to each section. Concerning plan governance, the EFRP finally proposes to apply the national rules of governance with the exception that the selection of employee representation be determined at the European level.

Finally, the EFRP suggested exploring the proposed approach further by undertaking a multilateral voluntary pilot scheme, including essentially the UK, the Netherlands and Ireland.

[21] *A European Institution for Occupational Retirement Provision (EIORP),* European Federation for Retirement Provision, July 2000.

6.2 The Pensions Forum and consultation of the social partners

As already shown above, the pension portability issue concerns both the free provision of services, the free movement of workers and necessarily also the free movement of capital. In this respect, the incompatibility of tax systems appears to clearly constitute the principal obstacle to both the free provision of services and the free movement of workers. Consequently the issue of pension portability is of importance for several Commission services: tax issues are of direct interest for the Taxation and Customs Union DG, the free provision of services is the responsibility of the Internal Market DG while the free movement of persons is one of the fields of responsibility of the Employment and Social Affairs DG.

With a view to further exploring the issue of free movement of persons in relation to supplementary pensions, the Employment and Social Affairs DG created in 2000 a consultative committee, called the "Pensions Forum", composed of representatives of member states governments, the European social partners and representatives of pension funds and the associations of elderly people at European level.[22]

The Pensions Forum first met in 2000 and was officially established by the Commission's Decision of 9 July 2001.[23] Its role is to assist the Commission in finding solutions to the problems and obstacles associated with cross-border mobility of workers in the area of supplementary pensions.[24]

In order to identify the most serious obstacles to mobility arising from supplementary pension schemes and to explore solutions already applied within member states that could be promoted at European level, the Pensions Forum set up three working groups in December 2000, concerning, respectively, the acquisition and preservation of supplementary pension rights, the transferability of supplementary pension rights and cross-border membership in supplementary pension schemes. Their reports were presented to the Pensions Forum plenary meeting of 23 February 2001.

Many of the obstacles identified by the three working groups affect workers moving between jobs within a given member state as well as workers moving from one member state to another. Consequently the three working groups have underlined that an action removing these obstacles should not be limited to cross-border mobility.

On the acquisition and preservation of supplementary pension rights, the first working group noted that many employers traditionally regarded supplementary pensions as a device for rewarding staff loyalty. This view has to be considered as out-dated, however. Supplementary pensions should be regarded as deferred income and as an essential component of social protection.

Long vesting and waiting periods and high minimum ages for scheme membership imply reduced supplementary pension rights for mobile staff. Such practices are no longer compatible with the increased mobility needs in today's labour markets and their

[22] Commission Decision of 9 July 2001, OJEC L 196, p. 26.

[23] Commission Decision of 9 July 2001 on the setting-up of a Committee in the area of supplementary pensions (OJ L 196 of 20 July 2001, p. 26).

[24] The following presentation of the work of the Pensions Forum is an extract of the Communication of the consultation of the social partners (see below).

social implications are, according to the working group's report, no longer acceptable. Moreover, high minimum ages and long vesting and waiting periods are discriminatory against women because they are more likely to take career breaks for family reasons.

The group therefore pronounced itself in favour of action to reduce waiting periods, vesting periods and minimum ages. It suggested that vesting should occur no later than one year after starting employment.

The group was aware of the fact that employers are likely to be concerned with the cost implications of shortened waiting and vesting periods. It therefore proposed to reduce them gradually over a transition period that could be identical to the current length of the vesting period. This would meet the concern that a sudden change in portability rules could cause unforeseen costs to employers and discourage them from offering supplementary pension schemes to their employees.

On the transferability of supplementary pension rights, the starting point of the second working group was an acknowledgement that before there can be a transfer there must be acquired rights. Once there are acquired rights, these can be handled in two ways: one possibility is the preservation of acquired rights, the other one is the transfer of a capital value.

Transferability should be an option for the employee, not an obligation. Nevertheless, there could be a need for setting up the legal framework that offers employees the right to opt for a transfer of acquired rights from one scheme to another – on a national as well as on an EU-wide level. The group concluded that it might also be necessary to define standards and principles for the calculation of transfer values and called for the creation of a group of experts to solve the technical problems regarding international transfers.

The Pensions Forum therefore convened a new working group in March 2002, in order to identify common solutions to the technical obstacles affecting the transferability of supplementary pensions in the European Union. The group has already presented a first set of proposals, but it also stressed that transferability presupposes the existence of a vested pension right. In this regard progress towards greater transferability also depends on improvement in the acquisition and preservation of supplementary pension rights and thus on a successful outcome of this consultation.

The third working group focused on cross-border membership as a way of facilitating workers' mobility and allowing them to change the country of employment without having to face the costs associated with an interruption in their pension scheme membership (e.g. costs arising from not having met vesting requirements, insufficient preservation and losses occurring in the case of transfers).

The group has stated that the main obstacle to cross-border membership is taxation. However, compulsory membership in an occupational pension scheme of the host country could also be a problem, since in that case cross-border membership would lead to double coverage.

The discussions in the Pension Forum, which followed the presentation of the reports by the three working groups, largely contributed to the focus of the first stage of consultation with the European social partners on the portability of supplementary pension rights, launched by the European Commission (Employment and Social Affairs

DG) in June 2002.[25] The Commission invited the social partners to give their opinion on the need for action in this field, and on the possible direction of a Community action on the portability of supplementary pension rights. In particular, it invited the social partners to answer the following questions:

1. Do you consider it advisable to take an initiative in this area? Do you share the Commission's view that the absence of a specific body of provisions concerning the acquisition, the preservation and the transferability of supplementary pension rights at European level has adverse impacts on workers and/or employers in the Internal Market?
2. If so, what form do you think action at European level should take (collective agreement, directive, recommendation, code of practice, guidelines, etc.)?
3. What should the main features of such a measure be?
4. Should action be taken at cross-sectoral and/or sectoral level?
5. Should such a measure apply equally to all supplementary pension schemes or should distinctions be made between supplementary pension schemes financed only by an individual employer and those financed jointly by employers and employees; between voluntary and mandatory schemes; between pension entitlements based on individual employment contracts and those based on collective agreements?

6.3 A Community prudential framework

In October 2000, in accordance with its May 1999 Financial Actions Plan as endorsed by the Cologne European Council in June of the same year, the Commission submitted a proposal for a directive with the aim of establishing a Community framework for prudential surveillance of occupational pension institutions.[26] An essential part of the Explanatory Memorandum provides a general overview of the situation with regard to the implications of the absence of a Community framework and the negative consequences of this gap:

The European Union now has detailed prudential rules for credit institutions, insurance companies and undertakings for collective investment in transferable securities (UCITS). These rules provide security for consumers and investors. A proposal for a Directive relating to the freedom of management and investment of funds held by institutions for retirement provision[27] *had to be withdrawn by the Commission in 1994 since no satisfactory agreement could be found in the Council. To date, the activities of IORPs have not been subject to any specific Community rules. This gap has several negative consequences.*

- *Investment. There is no agreement within the Community on how IORPs can use the single market and the euro to optimise their investments in financial markets.*

[25] Communication from the Commission, *First stage consultation of social partners on the portability of supplementary pension rights*. See also IP/02/846: Pensions: Commission decides to attack obstacles to job mobility in pension schemes.

[26] Proposal for a Directive of the European Parliament and the Council on the activities of institutions for occupational retirement provision, COM(2000) 507 Final (11.10.2000).

[27] COM(93) 237.

The rules to which they must adhere vary greatly from one member state to another. The possibility cannot be ruled out that some of these rules go beyond what is necessary to ensure the IORPs' prudential soundness. If so, this could hinder the application of the principle of the free movement of capital and damage the IORPs' returns. Between 1984 and 1998, average annual real return on investments by IORPs was around 6% in the member states with strict quantitative investment rules and more than 10% in member states with rules that give managers more freedom. Lower returns mean lower pay-outs or higher contributions. The indirect cost of labour rises, as does the cost of financing retirement systems. Investment policy in the field of supplementary pensions depends on the pension product and the contractual obligation of the pension provider. By limiting opportunities for diversification of assets, rules that are too restrictive might also complicate risk management and reduce the security of investment portfolios. Excessive restrictions on shares, which are usually less volatile than government bonds in the long term given their link to economic and productivity growth, can have a negative impact in this regard. It is therefore vital that an agreement be reached on investment rules that are suited to the more extensive and more liquid capital market that is the result of economic and monetary union.

- *Allocation of savings. IORPs have a key role to play in the integration, efficiency and liquidity of these markets. As very long-term investors, they are ideally placed to assist the financing of private initiatives. While the security and profitability of investment portfolios is a priority objective, a Community framework can also ensure that the IORPs participate in the efficient allocation of savings in the Union.*
- *Managing and custody of assets. IORPs may find themselves obliged to use only the services of custodians or asset managers established in the same member state as themselves. However, if IORPs are to be given the means of improving their investment policy, they must be able to choose their managers freely. Investment in a given sector or region may require the services or advice of a specialised manager, who may not necessarily be based in the same member state as the IORP. Furthermore, if competition between managers and between custodians were increased, this might help to cut management costs and make management more efficient. There ought to be specific community rules giving IORPs the right to use the services of managers duly authorised under the investment services Directive, the Directive on credit institutions and the third life-assurance Directive.[28] This right should be extended to management companies in accordance with a proposal for a Directive on UCITS[29] currently being discussed by Council and Parliament.*
- *Cross-border activities. In the absence of proper coordination at Community level, IORPs are the only major financial institutions unable to provide their services in a member state other than their own on the same conditions as banks, insurance companies and investment firms. It has been calculated that,*

[28] Directives 93/22/EC, 2000/12/EC and 92/96/EEC.

[29] COM(1998) 451.

for a pan-European company, the cost of setting up separate occupational systems in each member state is about EUR 40 million per year. Allowing IORPs to manage schemes for companies established in another member state would result in economies of scale of several types: more efficient investment policies as a result of asset pooling, simplification of administration and compliance with the prudential and reporting rules of a single supervisory authority. Furthermore, labour mobility would become easier: workers could more easily take up a job in another member state if they could remain members of the same IORP, as is foreseen, for posted workers under the terms of Title II of Regulation (EEC) No 1408/71, in Directive 98/49/EC on safeguarding the supplementary pension rights of employed and self-employed persons moving within the Community; multinationals would come up against fewer obstacles to moving their employees from one member state to another.

- *Growth of the IORPs. Promoting occupational retirement savings can help to balance the financing of pension systems and put state schemes on a sounder financial footing. This decision is for the member states to take and requires in particular that appropriate tax incentives be set in place. The existence of a legal framework containing European prudential standards and allowing cross-border management of occupational schemes would however be more conducive to the growth of IORPs than are the partitioning of markets and the regulatory patchwork that prevail today.*

Whereas the proposal, as stated, took account of the absence of agreement between member states concerning the liberalisation of pension fund asset management, the draft Directive goes as far as it can in proposing further steps towards an integration of the pension market while avoiding any interference in the organisation of pension systems in the member state. It follows the general principles of Community financial services legislation by proposing prudential rules differentiated according to type of pension scheme. However, the Directive covers all IORPs that are operating on a funded basis and are outside the social security system. In fact, any institution that receives contributions and invests them with the sole purpose of paying out retirement benefits is considered to be an IORP. It is underlined that the assets held by IORPs cannot be used for any purpose other than the payment of capital or an annuity at retirement. In other words, the rights acquired cannot be "surrendered" before the age of retirement.

The Directive will apply only to employment-related institutions for pension provision operating on a funded basis. The proposal, consequently, does not concern supplementary statutory social security schemes (first-pillar schemes) or third-pillar private, individual retirement schemes. Moreover, also certain second-pillar schemes assimilated with life insurance schemes and schemes in which there is no legal obligation to provide retirement benefits, such as the German *Unterstützungskassen*, are equally out of the field of application of the directive. Also the German system of book reserves are excluded from the field of application, since the firms sponsoring those schemes are not subject to any specific rules of asset management and since their obligations normally are covered by a guarantee or an insolvency insurance.

The few IORPs that operate on a pay-as-you-go basis or pension schemes operating on the basis of book reserves are also not covered by the directive. In fact, in the first category there is no accumulation of assets covering (fully) the pension liabilities and in

the second case there is no direct link between assets and liabilities of the scheme. Therefore, guaranteeing freedom of investment and management is in this case not applicable. Moreover, in the latter case, a guarantee or insolvency insurance fund generally replaces any prudential rules.

The draft Directive contains mainly provisions concerning items that are (or in recent years have been introduced as) "normal" features of pension fund operations in EU member states:

- Legal separation between the sponsoring undertaking and the IORP;
- Basic rules of operation, such as technical provisions and the obligation to provide information to members;
- The drawing-up of annual accounts;
- Disclosure of investment policy principles;
- Information to be provided and powers of intervention of the competent supervisory authority;
- The setting up of regulatory own funds and rules of investment;
- Free appointment of asset managers and custodians; and
- Notification of cross-border activities.

After close to two years of gestation, the Council, in November 2002, arrived at a common position. The text agreed by the Council maintained the core principles of the Commission's proposal. It established the principle of mutual recognition of supervisory authorities of the home member state (where the pension fund is located) and the host member state (where the sponsoring enterprise and the members are located), facilitated cross-border management and established more liberal investment rules. The major benefit of this directive will be to clarify the prudential rules imposed on pension funds in the various member states and hopefully to expand somewhat the scope for cross-border management and custody and cross-border activities. As indicated above, it is estimated that a large multinational company can save up to €40 million by pooling all its pension schemes in one fund instead of running different funds in each member state.

In general, the Directive can be considered to go as far as possible in the current context. Whereas the adoption of this Directive would entail a considerable clarification of market conditions and integration of the pension market, its provisions would provide only one of the conditions for a general rise in the portability of pension rights within and, notably, between schemes within member states and across frontiers. There is, consequently, still a need for examining and finding ways of increasing pension portability through the introduction of supplementary measures and schemes for removing as many of these remaining obstacles as possible to the free provision of services within the Union.

6.4 Means of improving cross-border portability

As seen from the preceding discussion, there are potentially a number of ways to improve cross-border portability of pension rights within the EU's internal market:

- Improvement of the scope for transferring the capitalised value of pension rights from one scheme to another;
- Coordination and increasing transparency in actuarial calculation of the pension liability (claim);
- Mutual recognition of prudential surveillance of pension funds;
- Elimination of national restrictions on the cross-border membership of pension schemes;
- Elimination of restrictions on deductibility of premiums to pension schemes in other EU member states; and a
- General shift to the EET principle of taxation of pension provision.

7 Conclusions and recommendations of the Task Force

7.1 General assessment

The CEPS Task Force considers the segmentation and inconsistency of the market for pension provision as one of the hurdles in the endeavours to complete the Single Market.

The Task Force members consider that the segmentation of the market for pension provision, including in particular restrictions on pension fund asset management and restrictions on the provision of pension services throughout the Union, entails considerable costs for all members of occupational pension schemes. In the end such costs are carried by the pensioners through a lower level of pension benefits or by the employers through higher labour and administrative costs with negative effects on both employment and business competitiveness. The elimination of remaining obstacles to a fully integrated market for pension provision is, therefore, also a social policy objective. The importance of this target will increase during the coming years and decades as occupational pension schemes are likely to carry a rising burden of overall pension provision in the Community.

We recognise that this is a difficult area where the sharing of competences between the Union and the member states is both complex and in several ways contradictory. We recall that the Commission's draft Directive on the liberalisation of pension fund asset management was withdrawn from the table of the Council due to substantial resistance by some member states to the Directive's provisions allowing asset managers to diversify their investments according to criteria of economic and financial efficiency. We stress, however, that this aspect of the freedom of capital movements remains an essential target.

We welcome the submission by the Commission of the draft directive concerning the prudential framework for IORPs and the recent formulation of a common position on this proposal by the Council. The adoption of this Directive will certainly contribute to remedying the present, divergent, national approaches to prudential surveillance of pension funds, one of the necessary conditions for providing increased portability of pension rights. Furthermore, portability should be enhanced by the Directive's provisions for mutual recognition of prudential surveillance and cross-border

membership. This Directive will thus help to remove a significant obstacle to the free provision of pensions throughout the EU.

We underline the particular benefits for the future member countries that will accrue from the adoption of a Community framework for the surveillance of pension funds.

We consider that the failure of most occupational pension schemes to offer adequate portability of pension rights is a serious obstacle to the free movement of persons within the Single Market. This is the case whether it is due to long waiting periods or backloading of pension benefits or, notably, due to tax-induced restrictions on (or prohibitive costs of) cross-border membership of pension schemes.

More specifically we consider that the segmentation of the pension market is a significant source of administrative and financial costs of all firms, but in particular of the increasing number of firms operating in the context of the Single Market and with an integrated European strategy for management of administration, production, sales and human resources. With an increasing number of posted and expatriate employees, these firms are frequently confronted with inextricable problems of provision of adequate pensions for these staff categories. The result is increased costs and loss of competitiveness.

We see several benefits accruing from increasing the portability of pensions and minimising portability losses in general:

- Increased portability will facilitate labour mobility both within and between member states. Whether a higher portability of pensions will actually result in an increase in labour mobility is uncertain. However, the free movement of workers within the single market is a fundamental right and we invite the Commission to continue to press for the elimination of all measures of discrimination between sedentary and mobile workers within the various pension regimes.
- Increased portability and, ultimately, the possibility of creating a unique pension fund for all staff members will lead to a reduction of administrative costs of the increasing number of firms undertaking cross-frontier production and distribution in an integrated approach.
- Revenues from occupational pension schemes are likely to improve as a result of increased competition and product development among scheme providers. With a better performance of second-pillar schemes, the pressure on first-pillar schemes will be alleviated. This is particularly welcome in view of the increasing pressure on first-pillar schemes over the coming years as a result of the ageing of the European population.
- Minimising portability losses without necessarily interfering with the basic nature of pensions schemes (which for many firms remain an essential feature of the management of human resources) will also contribute to a reduction of costs and an increase in the scope for enhancing flexibility in the labour market.

7.2 Recommendations and suggestions

In the course of its four meetings, the Task Force has discussed a number of issues in the field of pension portability, including general portability issues, the role of taxation,

methods of calculation of the actuarial value of pension claims and the relationship between pension portability and labour mobility.

As seen from the preceding discussion, there are potentially a number of ways to improve cross-border portability of pension rights within the EU's internal market:

- Improvement of the scope for transferring the capitalised value of pension rights;
- Coordination and increasing transparency in actuarial calculation of the pension liability (claim);
- Mutual recognition of prudential surveillance of pension funds;
- Elimination of national restrictions on the cross-border membership of pension schemes;
- Elimination of restrictions on deductibility of premiums to pension schemes in other EU member states; and a
- General shift to the EET principle of taxation of pension provision.

The recommendations and suggestions presented below focus mainly on these cross-border issues, that is, on the portability of pensions for workers moving between EU member states. In fact, as emphasised in a number of reports, portability of occupational pensions is in general low even within member states. We expect the share of occupational pension schemes in the total pension market to continue to rise in the coming decades. This will increase the importance of ensuring a certain degree of compatibility of pensions schemes in the member states (old and new!). We recommend that member states, preferably within a procedure of "open consultation" (see below), seek to agree on guidelines for "best practice" with respect to:

- vesting of pension rights;
- degree of backloading;
- procedures for adjusting vested pension claims for general inflation; and
- clarification of the approach to adjusting open-ended pension schemes for changes in life expectancy (as already introduced at least in one member state) and increased transparency of the actuarial standards for calculating the liability of pension schemes vis-à-vis their members.

The following sections focus on the cross-border issues we take as being of special importance for the approach to pension portability at the European level.

Regulatory issues

The common position agreed by the Council on 5 November on the draft Directive on the activities of institutions for occupational retirement provision is, as indicated above, a most welcome confirmation that member states are prepared to take steps in the direction of creating a fully integrated market for retirement provision. The Task Force invites the European Parliament to adopt without delay the draft directive in order to ensure a quick implementation of its provisions. However, once this Directive has been adopted and the necessary steps taken with respect to its implementation, further measures will be needed before it is even possible to envisage full integration of this market.

First of all, the framework for prudential regulation outlined in the Directive is, as should be expected, exclusively based on the principle of home country rule coupled with bilateral cooperation between member states to sort out cross-border issues. This may be appropriate during the first period of "running in" of the framework but will be insufficient in the longer run. In the long term the EU should, in our view envisage the creation of a formalised institutionalised framework for cooperation between national supervisory authorities.[30] In the intermediate phase, consideration should be given to the creation of a framework for cooperation between the supervisory authorities. This might be obtained by creating a "Conference of Pension Fund Supervisors" along the lines of the framework for cooperation existing in the field of insurance. An alternative will be to create a special working group under the Conference of Supervisors of Life Insurance. The agenda of this Conference/Working Group should include the following items:

- Vesting of pensions schemes;
- Methods of adjustment of vested pension claims;
- Methods of assessment of bio-metric risks, including the assessment of life expectancy during the coming decades;
- Exchange of information on procedures for providing information to members;
- Exchange of information on methods of surveillance of pension fund investment;
- Guidelines for funding of technical provisions and own funds;
- Actuarial standards for calculating the capitalised value of pension claims;
- Rules for transferring vested pension rights from one pension scheme to another (within and between member states);
- Rules for prudential surveillance of a European Institution for Occupational Retirement Provision; and
- Agreement of the definition of "best practice" towards which member states (old and new) should aim to converge.

The Task Force in this context notes the implications of the parallel discussions concerning the conditions for speeding up the legislative process of integrating banking, insurance and financial conglomerates (the Lamfalussy process). It noted in particular the EFC report's statement that the "modalities of the level 3 committees should closely follow those of the existing Committee of European Securities Regulators, subject to sectoral specificities" and recommending that the Conference of Insurance Supervisors be reformed into a new level 3 committee for insurance and pensions.

Cross-border tax issues

The Task Force fully supports the view of the Commission concerning the need to eliminate all tax-induced obstacles to cross-border provision of pension services. The

[30] For a general presentation of the current issues in the supervision of financial services within the EU, we refer to Karel Lannoo, *Supervising the European Financial System*, CEPS Policy Brief No. 21, May 2002.

Task Force therefore welcomes the Council's support for the establishment of a single market for occupational pension schemes by eliminating discriminatory tax-induced obstacles to cross-border pension portability inter alia by an intensified recourse to the exchange of information provided for in the 1977 mutual assistance Directive. Furthermore, the judgement in the Danner case by the Court of Justice will potentially contribute to paving the way towards the elimination of remaining tax-induced obstacles to cross-frontier pension portability. In our view the Commission is now in a position to step up pressure on member states to formulate a viable solution to the remaining issues in this field. It should be emphasised in this respect that the problems encountered to a large extent originate in the inconsistencies of the principles of income taxation in the member states. It would be advisable for member states, following the Danner ruling, to collaborate closely with the Commission in order to eliminate such inconsistencies and avoid future additional complications of the cross-border arrangements. The Task Force invites the Commission to carefully supervise tax measures taken by member states to ensure that such measures do not run against this principle.

The Task Force, in particular, recommends the general adoption of the EET principle as the basis for the taxation of pension schemes within the EU.

A pan-European pension fund

The Task Force considers that the creation of a European Institution for Occupational Retirement Provision (EIORP), as proposed by the European Federation for Retirement Provision and endorsed by the Commission, would constitute an important step towards the integration of the internal market in the field of pension provision.

We regret that this idea, so far, does not seem to have retained the attention of the Council but invite the member states, possibly within the framework of open coordination, to take steps to explore further the scope for undertaking a pilot scheme as initially suggested by the EFRP.

The consultation of the social partners

The procedure for consultation of the social partners initiated in June 2002 involves only a pre-selected number of representative organisations. Nevertheless, the Task Force takes the opportunity to volunteer our reply to the questions put forward by the Commission:

- ✓ *Do you consider it advisable to take an initiative in this area? Do you share the Commission's view that the absence of a specific body of provisions concerning the acquisition, the preservation and the transferability of supplementary pension rights at European level has adverse impacts on workers and/or employers in the Internal Market?*

As indicated above, the Task Force recommends an early creation of a "Conference of Pension Fund Supervisors" within the framework of the implementation of the Directive on IORPs. Whereas in general the cooperative arrangements within financial services cover only elementary rules of prudential surveillance, this Conference should also, in its agenda, include the rules for acquisition, preservation and transferability of supplementary pensions. We would advise against creating a parallel advisory body or "open cooperation" specifically addressing these aspects of pension schemes. We think

it is preferable to cover all aspects of the portability of pensions and sustainability of pension schemes within the same framework.

- ✓ *If so, what form do you think action at European level should take (collective agreement, directive, recommendation, code of practice, guidelines, etc.)?*

In the opinion of the Task Force this issue should be extensively discussed with the social partners. However, we doubt whether action at the European level could and should be taken in the form of collective agreement. Furthermore, we doubt whether the adoption of a Directive or even a recommendation concerning all aspects of the acquisition, preservation and transferability of pension rights would be possible and desirable in the present context. We therefore prefer the elaboration of codes of best practice and guidelines. The latter could, as indicated above, be elaborated within the framework of a "Conference of Pension Fund Supervisors". We would nevertheless invite the Commission to issue a general recommendation concerning the shortening of vesting periods in all defined-benefit schemes.

- ✓ *What should the main features of such a measure be?*

As implied in the answer to the preceding question, we consider that the portability of pensions and the prudential surveillance of pension schemes are matters still largely subject to the principle of "subsidiarity". We would, however, recommend that the social partners would be associated (possibly in special working groups) with the work of the Conference if it were to be created as proposed above.

- ✓ *Should action be taken at cross-sectoral and/or sectoral level?*

We would recommend taking whatever action is envisaged at a global (cross-sectoral) level.

- ✓ *Should such a measure apply equally to all supplementary pension schemes or should distinctions be made between supplementary pension schemes financed only by an individual employer and those financed jointly by employers and employees; between voluntary and mandatory schemes; between pension entitlements based on individual employment contracts and those based on collective agreements?*

We would have a preference for extending the procedures to all occupational pension schemes covered by the IORP Directive. This would include both schemes sponsored by an individual employer and those sponsored by a branch of industry. Whether or not a distinction should be made between pension entitlements based on individual employment contracts and those based on collective agreement is a matter on which the Task Force cannot judge. We would stress, nevertheless, that in the longer run we would expect an increase in the scope for the individual worker to select a pension provider in accordance with her/his lifestyle and career prospects.

Increasing flexibility and individual choice

We would, therefore, more generally, invite the Commission to consider the scope for increasing the flexibility in the provision of pension services, including (as is already the case in certain member states) opting out of a general pension scheme for a firm or a branch in favour of individual savings or pension schemes. This would imply offering better possibilities than is now the case of passing from second to third pillar schemes.

Future action in the field of pension portability should therefore also examine ways of increasing the scope for enhancing individual choice of retirement provision, as accompanied by adequate and extended rules of deductibility of contributions to all such schemes.

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GLOSSARY

Accrual of pension: The amount of pension benefit to which the individual will be entitled upon leaving a given job. This will depend upon the rules of vesting of pension rights and the degree of *backloading* of *defined-benefit schemes* (see below). In defined-contribution schemes, the accrual will normally be determined simply as the annuity to be obtained from the capital accumulated in the fund.

Actuarial fairness: The degree of (actuarial) connection between the contribution to a pension scheme and the benefit received from the scheme.

Annuity scheme: An individual (voluntary) pension scheme contracted normally with an insurance company and involving the payment of an annual (monthly) allowance. In most cases an annuity income will be subject to normal income taxation (on the assumption that the contributions to the scheme have been exempt of taxation). The opposite of an annuity scheme is a *capital payments scheme* (see below).

Backloading: A formula for determining the amount of pension benefits that involves a significant increase of benefits during the final years before the specified retirement age. Consequently, if employees leave the firm before qualifying for retirement they suffer a capital loss by giving up the opportunity for a substantial (over-proportional) increase in pension benefits. A formal model for pension loss due to backloading can be found in Alan L. Gustman and Thomas L. Steinmeier, *Pension Incentives and Job Mobility*, W.E. Upjohn Institute for Employment Research, Kalamazoo, Michigan,1995.

Book reserves: A pension scheme in which the employer guarantees certain retirement benefits, in return for which he sets up provisions on the liability side of the company's balance sheet. The company may use the corresponding asset at its discretion. In order to guarantee the solvency of the pension commitments, the "book reserves" are frequently covered by an insurance bond. Within the European Union, the system is notably found in Germany and Luxembourg and outside the EU, in Japan. At the end of 1989, the "book reserves" of German companies represented more than 400 billion DM or about 20% of German GDP.

Capital payments scheme: A retirement scheme normally contracted with an insurance company and involving the lump-sum payment upon retirement, premature disability or death. The capital may be subject to taxation as a function of the tax treatment of the contributions to the scheme (see *annuity scheme* above).

Cliff vesting: Under this provision, an employee achieves full vesting of his/her pension rights after a specified number of years. See also *graded vesting*.

Currency-matching requirements: Legally enforceable rules requiring a pension fund to maintain a currency structure of its assets corresponding to the currency denomination of its pension commitments. In the draft Directive on liberalisation of pension fund asset management and investment, the Commission has proposed that national currency-matching requirements should be satisfied also by investment in euro-denominated assets.

Defined benefit scheme: An occupational pension scheme in which the benefits are calculated by reference to the member's pensionable salary at or for a period before the normal pension date or date of leaving service and length of pensionable service. Defined-benefit schemes are also commonly referred to as "final salary schemes".

Defined-contribution scheme: An occupational pension scheme in which the member's contributions are used to purchase a pension by way of an annuity; the contributions may or may not be targeted to provide a particular amount of pension.

Early leavers' benefits: Benefits provided by occupational pension schemes for employees who, having completed a certain vesting period, leave pensionable service. As an alternative to leaving preserved benefits in his occupational scheme, an early leaver may ask for the value of his benefits to be transferred to another pension scheme or to receive a lump-sum payment representing the (capitalised!) value of his contributions.

Equity: A term that is regularly used as a synonym for own capital (total assets less borrowed funds). The equity of a company may thus typically cover the share capital plus various reserves attributable to the shareholders in the case of liquidation of the company. Book reserves being a counterpart of pension commitments towards employees thus would normally not be a part of the equity of a company.

401k pension plans: Defined-contribution pension schemes introduced by legislation in 1978 and effective as from 1981. Like traditional defined-contribution schemes, the 401k plans allow tax exemption of employer contributions, normally up to a certain limit of pay or profits, to all employees of a firm. In addition, however, 401 plans allow employees to make additional voluntary pre-tax contributions and allow firms to match these contributions. 401k plans now constitute the principal retirement scheme for small- and medium-sized firms in the US. Large firms, however, still, rely mainly on traditional defined-benefit schemes.

Funded scheme (in French, *capitalisation)*: A pension scheme in which the pension commitments (liabilities) towards the members are covered (in principle) by real or financial assets. The more precise commitment will depend upon the small print of the contracts, rules of indexation and such unknown factors as the mortality of the members. The degree to which the present-day value of commitments is covered by the assets can be assessed only by an actuarial calculation of the liabilities and a "prudent-man assessment" of the value of the assets. The rules for such assessments may be fixed by the prudential supervisors who may also fix procedures for dealing with discrepancies between the estimated value of assets and the actuarial calculation of present-day value of commitments.

Geographical mobility: Movement of persons (workers or inactive) between regions within countries or between countries (cross-border mobility).

Graded vesting: A method of calculating pension rights in which the percentage of rights in a defined-benefit schemes acquired increases during a certain "waiting time" until full vesting is achieved.

Indexation of pensions: A practice that includes many different kinds of automatic, semi-automatic or ad-hoc adjustment of benefits with the aim of maintaining parity with either a price index or with certain categories of income from active employment. Indexation may be implicit to the extent that a pension is calculated as a proportion of a certain category of active income.

Investment restrictions (obligation): Rules requiring pension funds and/or life insurance companies to invest a certain proportion of their assets in instruments of a certain kind. In practice, such investment rules will normally oblige the companies concerned to invest a certain proportion of their resources in government bonds or other domestic instruments (see also *currency-matching* and *localisation requirements*).

Labour mobility: A simple term covering in reality a number of different and complex phenomena. A distinction should be made between *geographical mobility* and *occupational mobility*. Occupational mobility may be seen from the point of view of the firm (job reallocation) or from the point of view of the worker (worker reallocation).

Life-cycle hypothesis: The theory formulated by Milton Friedman, according to which consumers take decisions concerning saving and spending not only on the basis of current income but with a view to distributing their spending through their lifetime in such a way as to obtain the highest overall satisfaction.

Localisation requirements: Rules requiring pension funds and/or life insurance companies to invest their resources in instruments of a certain origin. These requirements may overlap with *currency-matching requirements* and inve*stment restrictions* (see those entries).

Lump-sum distribution: A number of retirement schemes provide for conversion of the pension rights into a lump sum distributed before actual retirement. The actuarial value of defined-contribution schemes being more easily calculated, many of those plans offer scope for lump-sum distribution. According to data for the US, cashing-in of a lump sum is frequent among younger workers changing job.

Occupational labour mobility: Movement of workers between jobs (job reallocation), between employment and unemployment or in and out of the labour market.

Occupational scheme: A scheme that is organised at the level of the firm or the profession and in which the contributions are directly related to the wage bill of the employer. Occupational schemes may be either "defined-benefit schemes" or "defined-contribution schemes".

(Old-age) dependency ratio: A "dependency ratio" is a statistic providing an indication of the "burden" carried by the active population. The most commonly used dependency ratio is the old-age dependency ratio, which is defined as the ratio of people in the age group 65 and above to people in the active age group (15 to 64). Another dependency ratio is the overall dependency ratio, which is defined as the ratio of people in the age group 14 years and below plus 65 years and above to the number of people in the age group 15 to 64. Neither of these ratios takes account of the level of employment of the active population and may therefore give a biased picture of the real dependency in the economy.

PAYG (in French, *répartition)*: The "authorised" translation of the French term *répartition.* The original French *systèmes de répartition* were frequently confined to a profession, say dentists, and involved the "sharing out" to pensioners in this profession of the contributions paid in by the active members of the profession. As long as the overall demographic structure of a certain profession was stable, the system could be kept in balance. However, if the demographic structure of the profession showed significant changes (such as for example in agriculture, with few entries and a rising number of pensioners), the resources of the regimes would not be sufficient to ensure a "decent" pension to its members and the pressure was rising on the authorities to step in to cover the deficit (in which case the scheme is no longer one of *répartition* but similar to an ordinary national pension scheme). In practice, therefore, the terms PAYG and *répartition* cover a wide variety of un-funded schemes more or less equivalent, from a practical point of view, to a national, tax-financed pension scheme.

Personal-sector assets: The expression "personal sector" is normally synonymous with the "household sector" in the standardised national accounts terminology. Personal-sector assets will include all financial and real assets of the household sector except durable consumer goods. In some national accounts, the assets of the personal sector will also include the real productive capital of the non-corporate sector.

Portability of pension rights: The term used to indicate the degree to which a certain pension right can be transferred from one firm and/or country to another during the course of active life. The portability of pension rights is (together with the practical scope for moving from one dwelling to another) an important factor of "labour mobility" within and between member states. The *vesting period* (see below) is one important aspect of the portability of pension rights, but the rules for obtaining and keeping pension rights within the national PAYG systems may also significantly influence the cost to labour of changing employment and/or country. The draft Directive on the liberalisation of pension fund asset management and investment does not cover the portability of pension rights, but the Commission has announced its intention to present a draft Directive on the latter issue in due course.

"Prudent man" rule: The requirement that trustees or other administrators of pension fund assets are expected to observe the same kind of prudent behaviour as they would do when making investments on their own account (in Latin, *bonus pater familias).*

Replacement income: A term used to indicate the income attributed, in general, from social security to somebody losing his normal income either due to unemployment or retirement.

Rollover: The transfer of funds from one pension plan or one individual pension account to another pension plan or individual account without current income taxation of the capitalised value. The specific rules for rollover may be different from one country and tax system to another and may also be subject to regulation by prudential supervisory authorities.

Survivors' benefits: Lump-sum or annuity benefits provided by occupational pension schemes for survivors of a member who dies prior to retirement.

"Three pillars" of retirement provision: The classical distinction between i) national, PAYG-based pension schemes ("first pillar"), ii) statutory, occupational (funded) pension schemes ("second pillar") and iii) individual, voluntary schemes ("third pillar"). In practice, the distinction is difficult to make and some experts prefer to distinguish between four rather than three pillars.

Transferability of pensions: Defined by the European Commission in its Communication on "First stage consultation of social partners on the portability of supplementary pension rights" as "one specific way of achieving portability, namely by transferring a capital representing the acquired pension entitlements from one scheme to another". It is to be distinguished from the *portability of pension rights* (see above), which is far from being achieved either within or between member states.

Vesting period: The period during which the employee is requested to contribute to an occupational pension scheme before obtaining (portable or non-portable) pension rights. A long vesting period will, other things being equal, increase the cost of changing jobs and thus significantly reduce labour mobility. See also *cliff vesting* and *graded vesting*.

LIST OF TASK FORCE MEMBERS

Chairwoman: Elsa Fornero
Professor, University of Turino and Director of the Center for Research on Pensions and Welfare Policies (CeRP)
elsa.fornero@unito.it

Rapporteur: Jørgen Mortensen
Associate Senior Research Fellow, CEPS
j.mortensen@ceps.be

Dr. Elisabeth Alteköster
Head of Office
Volkswagen Liaison Office
elisabeth.altekoester@volkswagen.de

Mrs. Chantal Belliard
Adjointe au Directeur Retraite Prévoyance
Total Fina Elf
chantal.belliard@totalfinaelf.com

Ms. Cindy Bogaert
Scientific Collaborator
Vlerick Management School
cindy.bogaert@vlerick.be

Marco Bressa
Partner
Accenture
marco.bressa@accenture.com

Rosemary Bustin
Senior Manager
PricewaterhouseCoopers
rosemary.bustin@UK.pwcglobal.com

Mr. Yves Corne
Partner
Hewitt Associates
yves.corne@hewitt.com

Jean-Louis Davain
Partner
Deloitte & Touche
jdavain@deloitte.com

Mrs. Simonetta Di Cagno
Representative Brussels Office
Assonime
simonetta.dicagno@assonime.it

Mrs. Kerry Duffain
Director
Citigroup
kerry.duffain@citicorp.com

Barbro Eliasson
TryggLiv
barbro.eliasson@trygliv.seb.se

Brian Fox
State Street Corporation
bfox@statestreet.com

Johan Gahm
Manager Pensions & Life
SAAB AB
johan.gahm@saab.se

Mr. Simon Gilliat
Partner
Watson Wyatt Partners
simon.gilliat@eu.watsonwyatt.com

Alain Limauge
Head of Products Department
BNP Paribas Luxembourg
alain.limauge@bnpparibas.com

Ms. Kari Lotsberg
Senior Advisor
Confederation of Swedish Enterprise
(Svenskt Näringsliv)
karilotsberg@hotmail.com

Ms. Sonia Maffei
Consultant
Assonime
sonia.maffei@assonime.it

Helmut Martin
Commerzbank EU Liason Office
eu.office@commerzbank.com

Neil McPherson
Director
Citigroup Asset Management Ltd
neil.mcpherson@citicorp.com

Mr. Arnold J. Ouweneel
Manager Personal Tax
Shell International BV
arnold.j.ouweneel@si.shell.com

Richard Parlour
Partner
Richards Butler International
rsp@richardsbutler.com

Kris Pollet
EU Policy Advisor
White & Case
kpollet@whitecase.com

Rosemary Radcliffe
Senior Economist
PricewaterhouseCoopers
rosemary.radcliffe@uk.pwcglobal.com

Heidi Ranscombe
PriceWaterhouseCoopers
heidi.ranscombe@be.pwcglobal.com

Mr. Hywell Robinson
Solicitor
Clifford Chance
hywel.robinson@cliffordchance.com

Mr. Carl Johan Rundquist
Legal Counsel
SPP (Svenska Handelsbanken)
carljohan.rundquist@spp.se

Mr. Leonardo Sforza
Head Research & EU Affairs
Hewitt Associates
leonardo.sforza@hewitt.com

Mr. John J. Stewart
Senior Vice President
State Street Corporation
jjstewart@statestreet.com

Mireille Tissot
Member of the Board
Swiss Bankers Association
mireille.tissot@sba.ch

LIST OF SPEAKERS AND DISCUSSANTS

27 June 2001

Vincenzo Andrietti, Universidad Carlos III de Madrid and CeRP

Erik Lutjens, Professor, Free University, Amsterdam and external collaborator of William M. Mercer

Ralf Jacob, Directorate-General for Employment and Social Affairs, European Commission

Alain Jousten, Professor, University of Liège, Belgium

Philip Shier, Institute of Actuaries, Groupe Consultatif des Associations d'actuaires

25 October 2001

Peter Schonewille, Directorate-General Taxation and Customs Union

Marc Dassesse, Professor, Free University of Brussels

Geert T. W. Janssen, International Tax Policy and Legislation Directorate, Ministry of Finance, the Netherlands

Vincent J. Derudder, Secretary General, Fédération Européenne des Conseils et Intermédiaires Financiers

22 April 2002

Bart van Riel, Netherlands Social Economic Council

Paulo Campilho, European Commission Directorate-General for Employment and Social Affairs

9 December 2002

Fabiana Pierini, European Commission Directorate-General for Employment and Social Affairs

Peter Schoneville, Directorate-General Taxation and Customs Union

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1 Place du Congrès
1000 Brussels, Belgium
Tel: 32(0)2.229.39.11 Fax: 32(0)2.219.41.51
E-mail : info@ceps.be Website: http://www.ceps.be