Lithuanian Free Market Institute

Policy Brief

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Personal Pensions in the European Union

Executive summary

Issues	Policy proposals
The development of personal pensions at the national and cross-border levels is hindered by high compulsory payments to public pension funds, restrictions on the participation of the self-employed and the unemployed, rules governing access to retirement savings, taxation of retirement income and other national legal requirements.	Member States should reduce red-tape, allow for more flexibility in choosing personal pension schemes, promote cross-border personal pensions through a preferential tax treatment of employer and/or employee contributions and provide saving options for self-employed and temporarily unemployed individuals.
Unstable legal regimes (frequent policy shifts and uncertainty regarding policy sustainability), over-regulation (price caps, regulation of investment strategies and contribution rates) and a general lack of a long term vision hinder the provision of cross-border pensions and create barriers to entry for pension providers.	Member States should ensure policy continuity and refrain from changing national policies on long-term investment products in the pursuit of short-term goals. Sustainable policies and the removal of anti-competitive restrictions that would allow market players to develop personal pension products are of paramount importance.
Insufficient public policy incentives to stimulate saving in personal pension products and active promotion of incumbent mandatory state pension schemes, combined with large compulsory payments to public pension funds, reduce opportunities for private savings and decrease the demand for personal pensions.	Rather than promoting inflexible and costly compulsory state pension schemes, Member States should diversify investment options that would expand retirement saving choices and allow individuals to choose the best investment tools based on individual needs, consumption patterns and opportunities.

Policy context

The principle of free movement of capital, goods, people and services comprises the main pillar of the European Economic Area. Excessive national regulation, however, prevents EU Member States from reaching its full potential, particularly in the free movement of capital which is subject to extensive regulation at the national level. With the aim of strengthening the single market for capital, the European Commission will assess the case for a policy framework to establish European personal pensions.

Commendably, the Commission acknowledges the need to encourage more savings into personal pensions in order to secure adequate revenues for retirement, especially as the ratio of retired people to workers is expected to double by 2050. To that end, the Commission has announced a public consultation to identify potential obstacles to the uptake of personal pension products and ways to best address them, also stressing the need of deregulation and higher transparency in personal pension products. The Commission is seeking advice on issues that hamper the development of cross-border personal pensions.

As a potential solution, the Commission sees several approaches:

- Establishing a Personal pension account: a personal pension account such as the Individual Retirement Account (IRA) offered in the United States would be introduced at the EU level. According to the Commission, the proposed cross-border saving account would ensure higher access (especially for migrant workers), multiple ways of contribution and participation of temporarily unemployed individuals in personal pension saving schemes, allowing potential savers to benefit from the free movement of capital and services.
- Establishing a Personal pension product: a personal pension product could be developed based on a set of common and flexible features with a specific retirement objective. Such features might cover transparency and disclosure requirements, investment options, accumulation and decumulation phases, distribution models, consumer contractual rights, guarantees and fees and charges. This would be set out at the EU level through a legislative act;
- Harmonizing national personal pensions regimes: under this approach, personal pension requirements would be harmonized across Member States in terms of prudential supervision, possible providers, maximum costs, contract law, distribution models, etc.; however, tax requirements applicable to personal pension products would still be determined at national level.

On the proposed establishment of the European Retirement Account

The proposed European Retirement Account, which is supposed to address the existing imperfections of public and personal pension schemes, provide wider access and multiple ways of contribution and be subject to limited predefined rules of investment, has the following features:

- It may be provided and managed by a variety of institutions, including banks, insurance companies, funds, etc.
- May be opened by any EU citizen in any Member State.
- Profits on the account as well as withdrawals after reaching the age of retirement will not be taxed. Contributions will be subject to taxation, unless tax incentives are provided by national legislation.

- The account will allow pre-retirement withdrawals subject to limited penalties. Withdrawals in case of specific hardships will not be penalized;
- A lump sum withdrawal will be allowed upon reaching the age of retirement.
- The age of retirement will not be harmonized and will depend on the saver's country of tax residence.
- The account providers will have to offer default low-cost investment strategies.
- The account will be portable both within and across Member States.
- Annual performance reports will be used to ensure transparency of the fees paid.
- There will be no mandatory guarantee on the accounts to maximize the return on investment and avoid the impression of a risk-free investment.

Though it is designed to tackle a number of key policy issues, the proposed European Retirement Account does not address the problem of high compulsory contributions to public pension schemes. As taxation remains at the disposal of individual Member States, a fully functioning product which may serve as an alternative or supplement to public pension schemes will still depend on the political will of individual Member States.

National legal requirements limit the development of national and cross-border personal pensions

As rightly pointed out by the Commission, varying national legal requirements limit the development of personal pensions both at the national and cross-border levels. Currently, a vast majority of personal pension regimes are based on national labour and social security laws as well as subject to national tax regulations. Saving for retirement in pension funds is not only tied-up with state subsidies, but private savings themselves are redistributed by national pension administration institutions and treated as the expenditure of the state pension fund rather than private property.

Moreover, individual Member States apply different rules for participation in private pension schemes that vary from restrictions on the participation of the self-employed and the unemployed to provisions governing access to retirement savings to taxation of retirement income and other country-specific regulations. High compulsory employer or/and employee contributions to public pension funds are of major concern when it comes to the development of personal pensions. For example, in Lithuania over 20 percent of employee salary (gross) is deducted as a mandatory contribution to the state pension scheme, leaving virtually no room for the development of innovative and efficient national and cross-border personal pensions that may compete with the incumbent state pension system.

In order to overcome the current stagnation of personal pension development, advance more innovative and more efficient personal pension products and allow cross-border personal pensions to function properly, the European Commission should encourage Member States to:

- reduce red-tape and seek deregulation;
- allow for more flexibility in choosing personal pension schemes;
- promote cross-border personal pensions through preferential tax treatment of employer and/or employee contributions;
- provide saving options for self-employed and temporarily unemployed individuals; and
- promote competition by leaving the development of personal pension products to market players.

The abovementioned measures would increase competition, promote innovation and encourage investors to develop competitive products for personal pension saving. In turn, consumers could benefit from simpler, more innovative and efficient personal pensions to complement their retirement income.

Unstable legal regimes hinder the provision of cross-border pensions

Uncertainty in policy continuity is yet another issue that needs to be tackled by the European Commission if the goal is to facilitate the provision of cross-border pensions. Combined with extensive regulation, the instability of national legal regimes for personal pensions and private saving deters investment into cross-border pension products, not to mention the regulations that Member States apply on price caps, maximum contribution rates and investment strategies of private pension funds.

For example, from 2003 through 2013 the Lithuanian Law on Pension Saving was amended more than ten times. For investors, this signals a lack of a clear long-term vision on pension policy. Continuous policy debates about creating legal possibilities to switch from private to state pension schemes add to this uncertainty. Obviously, such an environment is not conducive to attracting investment into the provision of cross-border pensions which by their very nature are long-term investment products that require stable legal regimes as a paramount condition.

To facilitate the provision of cross-border pensions by removing current barriers to entry for providers, Member States should ensure long-term policy continuity and refrain from changing national policies on long-term investment products in the pursuit of short-term goals. If combined, the removal of anti-competitive restrictions on the provision of cross-border pensions and sustainable policies would attract investment, allow market players to develop innovative products and allow citizens to save for retirement in effective, transparent and, most importantly, portable accounts. This will benefit both consumers and the market for personal pension products.

Insufficient public policy incentives discourage citizens from saving in personal pension products

Insufficient public policy incentives for saving in personal pension products are seen as a major concern regarding a low demand for personal pensions. Indeed, current policy solutions and ongoing debates do not seem to encourage the choice of personal pension products. The reasons behind this are manifold:

- The existing mandatory state pension schemes foster a paternalistic approach whereby individuals are forced to recognize that the state is best-positioned to provide for retirement;
- individuals are not in a position to decide on the amounts of their contributions to pension saving accounts;
- individuals are not in a position to freely choose which saving tools, public or private, to rely on for their retirement;
- access to pension rights and retirement are strictly regulated, and pension fund and retirement income are subject to taxation;
- the portability of personal pensions is limited, and changing pension funds is severely restricted.

Clearly, Member States discourage personal pensions by upholding inflexible and costly compulsory state pension schemes, limiting individual choice and restricting portability of personal pensions and competition through restrictions on movement between Member States and replacement of pension funds. To increase the demand for personal pensions, Member States should allow individuals to choose the best investment option based on individual needs, consumption patterns and opportunities.

Flexibility is of major importance when it comes to long-term investment products, especially those focused on retirement. Investors' preferences and needs could change over lifetime. Pension account holders might like to move their personal pension accounts both within the state by changing pension funds as well as across Member States, which is also very likely given the current development of cross-border career prospects. Flexibility of personal pensions would create incentives to participate in personal pension schemes as people would have more control over their investment. Likewise, portable pension accounts would make personal pensions a more attractive option for mobile workers with the view of keeping their pension contributions together.

Conclusion

If the above-mentioned challenges were overcome, a truly functioning market for personal pensions could create a number of benefits and contribute to the growth and investment within the single market for capital. Increased competition would bring more product innovation, better prices and a wider range of personal pension providers. Furthermore, the transparency, simplicity, flexibility and portability of products would make personal pension saving more attractive to individuals. Finally, by pooling assets from a larger investor base, providers could also benefit from reduced complexity, easier cross-border activity and greater efficiency.

To achieve this, barriers for the internal market should be removed, and cross-border solutions should not be hampered by regulatory mechanisms. Increased competition and portability and better access to personal pension products should remain the focal point if the aim is to strengthen the single market for capital.

The EU or national regulators should not interfere more than it is necessary to reduce barriers to entry for providers or to take necessary action to denationalize public pension regimes (labour, social and tax law) and expand choice to savers. The development and design of personal pension products should be left to the market and service providers. Compulsory provision of any product might lower unit costs in the short term, but it would undermine innovation, efficiency and market competition in the long run.

Any attempt to harmonize European regulation of personal pension products would pose a risk that, instead of creating a market conducive to the development of innovative and competitive products, Europe will end up with a patchwork of regulatory requirements and market inefficiency. It is therefore important that policy is focused on creating conditions for sustainable long-term solutions while keeping regulation to a minimum.