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Legal and economic general report

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Introduction

All over the world, countries are facing increasing fiscal problems related to the financing of pensions. In most countries life expectancy is increasing and birth rates are declining. There is widespread concern about the sustainability of pension systems as populations are ageing. It reflects the global character of the problem that international organizations and institutions have conducted extensive research on the ageing problems. The Nordic countries have a common tradition for taking actively part in international cooperation. This implies that reports on the economic consequences of ageing and pension issues published by the World Bank, OECD and EU institutions have impacted on the design of pension systems in the Nordic area.

It is well known that the Nordic countries belong to the richest countries in the world. Measured by national income per capita, the Nordic countries belong to the group of the ten richest countries. They have also a very high level of taxation and a high minimum level of pensions. The life expectancy in the Nordic countries is very high compared to the world average. According to OECD (2005), the five countries with the longest life expectancy are Japan, Iceland, Norway, Sweden and Switzerland.[1)]

In 1994, the World Bank recommended that countries should base their pension systems on a multi-pillar model. [2] In practice, the recommendation was interpreted as meaning a Three-Pillar Model. The first pillar should be a state-run PAYG pension. The second pillar should be mandatory membership of a privately managed funded pension scheme, while the third pillar should be an appropriate legal framework for voluntary contributions to funded pensions.

As explained in the National reports below, all the Nordic countries have chosen a Three-Pillar Model although the relative importance of the individual pillars varies. The broad picture in the Nordic area is that the first pillar is based on a tax-financed public pension. The second pillar is dominated by mandatory occupational pension funds, while the third pillar is based on voluntary pension saving with different kinds of tax incentives.

Pension systems are designed to make it possible for the citizens to redistribute their consumption possibilities over their life time. The systems allow transfer of consumption

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[1] Pensions at a Glance: Public Policies across OECD Countries, OECD, Paris, 2005. p.3 in Summary.
[2] Averting the Old Age Crisis, World Bank and Oxford University Press, New York 1994.

possibilities from the productive middle years to the period of retirement. Pension systems also make it possible for people to insure against the risk that they should outlive their savings. Governments and Parliaments interfere by legislation in order to create an appropriate framework for the reallocation of consumption possibilities over time and for risk reduction by insurance. An additional public policy objective of great importance in the Nordic area is redistribution of income in favor of low-income groups thus complementing the role of progressive income taxes. Pensions policy can finally aim at economic development and growth since pension arrangements can assist the operation of labor and capital markets and may encourage saving.

There are considerable differences between the OECD countries in the proportion of people above the age of 50 on the labor market. Labor-force participation in 2004 is two out of three for the 50 to 64 year olds in the Nordic countries, in Switzerland, Japan and several English-speaking countries. The old age participation rates on labor markets are significantly lower in Central and Southern Europe.[3]

Recognizing the value of a certain degree of uniformity in basic principles and formulations, OECD's Committee on Fiscal Affairs has recommended that the member states follow the most recent version of the OECD Model Tax Convention on Income and on Capital when negotiating new double-taxation treaties.[4] Articles 18, 19 and 21 in the OECD Model deal with cross-border pensions. According to the OECD model art.18 and 21, pension benefits can only be taxed in the state of residence. However, in treaty negotiations *Iceland, Norway*, *Sweden*, *Finland* and *Denmark* seek to establish a right for the state of source to levy withholding taxes on all pensions, private as well as public. The Nordic Double-Taxation Treaty gives the right to tax to the state of source.[5]

In the context of efforts to create an internal market for financial services, The European Commission has published a communication concerning the principles according to which pension contributions and pension payments should be taxed.[6] The focus in the communication is primarily on the second pillar pension schemes, but the Commission notes that much of the discussion in the communication applies equally to third pillar pension and life insurance services. The Commission recommends application of the socalled "EET tax principle." This principle implies that contributions from employees and employers should be tax exempt, the yield on pension funds likewise while payment of pensions should be taxed at the recipient. More recently, the European Parliament and the EU Council have adopted a Directive on the activities and supervision of institutions involved in occupational retirement arrangements.[7] As explained below, *Norway*, *Iceland*

[3] Whiteford, Peter & Whitehouse, Edward, 2006, Pension Challenges and Pension Reforms in OECD Countries, *Oxford Review of Economic Policy,* Vol. 22, No.1, 78-94.
[4] Articles of the Model Convention with Respect to Taxes on Income and on Capital, As they read on 15. July 2005, OECD, Paris, 2005.
[5] Convention Between the Nordic Countries for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, Effective January 1, 1998. Copenhagen, Helsinki, Oslo, Stockholm, Reykjavik, September 1996.
[6] Communication from the European 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.
[7] Directive 2003/41/EC of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision. According to the OECD Working Party on Private

and *Finland* have chosen to follow the EET tax principle, while *Sweden* and *Denmark* follow the ETT tax principle. The Nordic pension tax systems vary in particular in the treatment of yields on pension portfolios.

The authors of the National reports have been asked to structure their papers according to the following seven headlines:

1) Certainty or uncertainty concerning contributions and benefits?
2) Demographic trends and retirement behavior.
3) Tax treatment and life cycle period.
4) Balance between mandatory and voluntary pension arrangements, level of public pensions and degree of freedom.
5) Issues of fiscal sustainability.
6) International mobility of labor and capital.
7) Implications for capital markets and financial stability.

The remaining part of this general report is organized in a similar way.

1. Certainty or uncertainty concerning contributions and benefits?

A first distinction must be made between defined-benefit plans (DB-plans) and defined-contribution plans (DC-plans). In a DB-plan, current and future contributions are determined by the benefits that will eventually be provided to the pensioner. The defined pension level may be determined as a given fraction of the wage of the employee during a certain period. So, future benefits are in principle known ex ante with certainty while the contribution level that will be necessary for the funding is unknown.

In a DC-plan, future benefits are determined by the accumulated contributions and the investment performance of the manager of the pension portfolio. Thus, contributions are in principle known ex ante with certainty, while the future level of benefits is unknown.

Note the use of the words “in principle” above. There are of course always factors that introduce uncertainties. Future payment patterns depend on the development of prices and wages, on retirement ages and life expectancies. In addition, the projected rates of return on pension portfolios are uncertain.

There is also a political risk in the sense that Parliaments in the future might decide to tighten the pension eligibility criteria or reduce the pension level.

In 1998, Sweden introduced into its public pension system a socalled “Notional defined-contribution scheme (NDC).[8] It can be characterized as a DC-plan financed on a pay-as-you-go (PAYG) basis. Each employee pays a contribution of *x* per cent of his earnings,

Pensions, recently published OECD Guidelines on funding and benefit security are consistent with Directive 2003/41/EC.

[8] Sundén Annika, 2006, The Swedish Experience with Pension Reform, *Oxford Review of Economic Policy,* Vol. 22, No.1, p.133-48.

which is credited to a notional individual account that is the state "pretends" that there is an accumulation of financial assets. The accumulated balance of the account is credited with a notional interest rate, specified by the Government, and chosen to reflect what can be afforded. The last mentioned provision implies that employees must accept to be exposed to some level of uncertainty concerning their future pensions. At retirement, the value of the person's notional accumulation is converted into an annuity assuming mortality rates based on the employee´s birth cohort and age.[9]

Exhibit 1: Overview of the main schemes in the three pillars of the pension systems in the Nordic countries.

	Pillar 1	Pillar 2	Pillar 3
DK	DB	DC	DC
FI	DB	DC?	DC
NO	DB	DB/DC	DC
SW	DB/NDC	DB/DC	DC
IC	DB	DB/DC	DC

Pension taxation rules modify the (uncertain) payment patterns related to the pension types described above. Pension taxation implies that after-tax payments are different from before-tax payments both in the contribution period and in the retirement period.

Balance between defined-contribution pension plans and defined-benefit plans

In *Denmark*, pillar one is dominated by a general peoples´ pension (folkepension, FP) which does not require prior contributions or employment. The Danish FP is a tax-financed DB-pension. The main principle in Danish occupational pensions is the DC-

[9] Barr, Nicholas & Diamond, Peter, 2006, The Economics of Pensions, *Oxford Review of Economic Policy*, Vol. 22, No.1, p.19.

principle, but the big role of the FP means that DB-pensions will dominate pension payments in Denmark many years ahead.

The pension system in *Finland* is primarily based on the DB-principle and the first pillar is very strong. The third pillar consists of private voluntary pension insurance. Voluntary private pensions are clearly of the DC-type and they are fully funded.

In *Norway*, there are laws on occupational pension schemes containing provisions on both DB-pensions (OPA) and DC-pensions (DCA). All Norwegian public employees are covered by DB-pension schemes. About half of the employees in the private sector were up to 2006 covered by occupational pension schemes predominantly of the DB-type.

The pension system in *Sweden* adheres in principle to the Three-Pillar System dominant among member states in the EU. The first pillar represents state pensions and combines retirement pensions, disability pensions, and survivor pensions in one unified approach. Two parallel public pension systems are in force in a long transition period. The old system consists of a flat-rate DB-Scheme and a supplementary ATP-pension scheme. The new system consists of two DC-schemes. One is the NDC-Scheme mentioned above the other is a funded DC-system. Also pillar two – the private mandatory occupational pension system in Sweden – includes both DB- and DC-components. In the long run, the overall balance is expected to move from DB-schemes to DC-schemes.

The occupational pension system in *Iceland* is a hybrid between a DB-system and a DC-system. The pension fund of state employees is the biggest public sector pension fund in Iceland and provides the most important DB-pension plan in the country. The balance between DC-pension plans and DB-plans is approximately 65 vs. 35. There has been a trend towards DC-plans in Iceland, but the phase is slow.

Statistics on the number of persons participating in the two types of plans, assets of pension institutions and trends.

The total *Danish* population is when reaching the minimum age entitled to FP which is of the DB-type. All Danish wage earners are members of the mandatory supplementary pension scheme Arbejdsmarkedets Tillægspension, ATP and entitled to ATP-pension of the DC-type. 90 per cent of all wage earners contribute in addition to a labor market pension under a framework negotiated between unions and employers´ organizations. Pension institutions offer primarily pension arrangements of the DC-type and they invest most of their assets in bonds. As all funded pension schemes are of the DC-type, it is obvious that DC-schemes will play an ever increasing role in the Danish pension system.

In *Norway,* approximately 1.4 million employees in the public and private sectors are covered by DB-schemes. Approximately 130,000 persons employed in the private sector are covered by DC-pension schemes. The share of DC-schemes is likely to increase considerably in 2006 and the following years as mandatory occupational pension schemes are phased in. About 600,000 persons are likely to be enrolled, primarily in DC-schemes.

In *Sweden* in 2003, approximately 2.2 million persons received benefits from the public pension system. The number of persons in the private sector covered by private mandatory occupational pension schemes (avtalspension) was 2.6 million employees. Pension schemes for employees in the public sector covered 1.38 million persons.

The majority of *Icelandic* pension funds are broadly based on the DC-system. At the end of 2005, there were 181,393 pension fund members. There is a trend towards DC-pension plans.

2. Demographic trends and retirement behavior

The total population and the proportion of the population aged 65 or over in the Nordic countries are presented in Exhibit 2.1.

Exhibit 2.1: Total population and population aged 65 or over in the Nordic countries 2005

	Total population (000)	per cent 65 years or over
DK	5411,4	15,0 %
FI	5236,6	15,9%
NO	4606,4	14,7%
SW	9011,4	17,2%
IC	293,6	11,8%
Sum Nordic countries	24559,4	
EU (25)	461297,9	

Source: Eurostat, http://epp.eurostat.ec.europa.eu/portal/page?

The life expectancies at birth and at the age of 60 are presented in Exhibit 2.2.

Exhibit 2.2: Life expectancy at birth and at 60 in the Nordic countries 2004/2003

	Life expectancy at birth		Life expectancy at age of 60	
	Men	Women	Men	Women
DK	75,2	79,9	19,3	22,7
FI	75,3	82,3	19,5	24,0
NO	77,5	82,3	20,7	24,4
SW	78,4	82,7	21,0	24,6
IC	79,2	82,7	22,2	24,8

Source: Eurostat.

In *Denmark* the average life expectancy at birth is 75,2 years for men and 79,9 years for women. The average retirement age is 62 years. The average pension period is according to the statistics used in the National report 17.7 years for men and 20.8 years for women. At the age of 65, Danish citizens obtain the right to receive peoples´ pension (FP). It has recently been decided by the Danish Parliament to increase gradually the minimum pension age to 67 years from 2024 to 2027.

Under the socalled Efterlønsordning (After Wage Arrangement), people who retire from the labor market in the age interval 60 to 64 years can obtain income support. The scheme gives a certain incentive to retire before the age of 65. It has also recently been decided to increase gradually the minimum age in the After Wage Arrangement from 60 to 62 years from 2019 to 2022. Payment of ATP-pensions starts at the age of 65 but can be postponed on the initiative of the pensioner.

In *Finland*, the average life expectancy at birth is 75,3 years for men and 82,3 years for women. The average length of the pension period is close to 20 years. Since 1995, the average retirement age has increased by one year and the average life expectancy has also increased by one year.

The Finnish pension system provides incentives to stay on the labor market since the pension increases by each additional year at work. Since 2005, the minimum retirement age has been 62 years. In occupational pension schemes, the Guideline of the National Board of Taxes refers to the age of 55 as the earliest retirement age.

In 2005, the expected age of *Norwegian* women was 82.5 years and of Norwegian men 77.7 years i.e. slightly more than the 2004 numbers in Exhibit 2.2. Labor force participation defined as the proportion being employed or actively seeking employment was 72.3 % in 2005 against 62.2 % in 1975. Most people enter the labor force at some point before they reach 24 years. During the last 30 years, the labor force participation of men has fallen dramatically for the age of 62 and onwards. During the same years, the labor force participation of Norwegian women aged 55 has increased.

The foundation of the Norwegian old age pension system is the pension scheme under the National Insurance Scheme (NIS). The AFP pension scheme (Avtalefestet pensjon) is a scheme for persons in the age group 62-66 years. It is based on collective agreements between unions and employer associations and covers a majority of employees (maybe 80 %). Employees (formerly) in the public sector are allowed their full occupational pension scheme allowance from age 65.

The nominal retirement age in Norway is at 67 years. There is no incentive to stay longer, since by continuing in a full time job, the pension will be reduced by at least 20 per cent of the labor income.

In *Sweden* in 2004, the average life expectancy at birth was 78.4 years for men and 82.7 years for women. The average residual life time for 65 year old Swedes was according to the National report 16.78 years for men and 20.08 years for women. Among the Nordic countries, Sweden has the highest proportion (17.2%) of people aged 65 or over cf. Exhibit 2.1. The normal retirement age in the old pillar-one system is 65 years. Under the new pillar-one system, retirement is possible from the age of 61 but can be postponed to the age of 67. In the private mandatory occupational pension system the earliest retirement age is 55 years.

In 2004 in *Iceland*, the average life expectancy at birth for men was 79,2 years. This is the longest expected life time for men in the Nordic area. The life expectancy at birth for Icelandic women was 82.7 years corresponding to the expected life time for Swedish women. Iceland faces smaller problems due to ageing of the nation than most developed European countries. The population is younger and the fertility rate relatively high. The proportion of people aged 65 or over was in 2005 11.8% which is by far the lowest number in Exhibit 2.1. Public pensions are not paid before the age of 67 and regulations governing the pension funds do not give any incentives for early retirement. So, in Iceland the labor market participation rates of the elderly are higher than in most developed countries. The average retirement period was 14 years for men and 19.5 years for women.

3. Tax treatment and life cycle period

Exhibit 3 provides an overview of the tax treatment of respectively pension contributions, yields on pension portfolios and pension income in the Nordic countries.

Exhibit 3: Tax treatment of contributions, yields on pension portfolios and pension income in the Nordic countries

	Contributions	Yields	Pension income
DK	E, L	T	T
FI	E, L	E	T
NO	E, L	E	T
SW	E, L	T	T
IC	E, L	E	T

Note: E: Exempted for tax, L: Limits on deductibility, T: Taxed

In all Nordic countries preferential tax treatment is given to contributions paid to pension schemes, whereas tax is levied on pension benefits. This results in a deferral of taxation from a person's working age to his retirement age; thereby income smoothing is achieved.

As a general rule the preferential treatment involves deduction of contributions in the taxable income. When an employer pays a contribution he has a right to deduct at the time of payment, while the employee pays no tax on the contribution. Pension benefits are generally subject to tax and treated as taxable income at a progressive rate.

However, *Denmark*, *Finland* and *Norway* have exceptions to this rule, which are related, in particular, to individual pension schemes. These exceptions entail that the value of the deductions relating to contributions are reduced, whereas pension benefits are taxed at a reduced rate. In *Finland* the value of deductibility of contributions to individually signed insurance contracts is 28% (as capital income) while pension benefits from such schemes are taxed at a rate of 28%. In Denmark the value of deductibility related to contributions paid to a capital pension scheme is deductible at a tax value of 39% to 45%. Lump sum payments under capital pension schemes are taxed at a special rate of 40%. In *Norway* contributions under individual pension saving agreements would have effect upon the computation of the 28% tax on general income only. Payments received are taxable as pension income. The Norwegian Ministry of Finance has, however, announced that payments under individual pension agreements made after 12 May 2006 shall not be deductible at all.

All the Nordic countries limit the maximum tax-privileged amount that can be paid as contribution to a pension scheme. Those maximum amounts vary considerably from one country to another. In *Iceland* deduction for contributions to individual pension funds cannot exceed 6% of the contribution base, 4% maximum for the employee and 2% maximum for the employer. In *Finland*, contributions to a private pension insurance scheme cannot exceed EUR 5,000 per year (EUR 2,500 per year if the employer has also paid contributions to a voluntary individual pension plan). If an employer signs an individual contract for an identifiable wage earner, contributions up to EUR 8,500 are not considered as taxable income at the hands of the employee. In *Norway* a Norwegian tax payer has up to now been entitled to deduct contributions up to NOK 40,000 under individual pension saving agreements. In *Sweden* an employer's contribution may not exceed 35% of the employee's salary nor the equivalent of 10 "base amounts" (i.e. currently 10x39,700 SEK = SEK 397,000) on a yearly basis. Individuals' contributions to private pension schemes may, as a main rule, not exceed 0.5 base amounts (i.e. currently SEK 19,850) on a yearly basis. In Denmark the limit is currently DKK 42,000 for contributions paid to capital pension schemes, but the right to enjoy preferential tax treatment is in principle without limit for contributions paid to schemes with periodic pension payments until death or schemes with periodic pension payments for at least 10 years.

Finland, *Iceland*, *Norway* and *Sweden* have no yield taxation. *Denmark* and *Sweden* levies a tax of 15% on the yield. In both these countries, the pension institutions pay the tax. However, the basis for calculating the tax varies considerably. In *Denmark,* the current return and portfolio appreciation per year is taxed (i.e. no taxation in years of negative results), while in *Sweden* tax is calculated on the basis of a notional income calculated by multiplying the capital base by the average yield on Swedish state bonds during the year preceding the income year. The fact that Denmark and Sweden levy a yield tax reduces the revenue impact of granting a relatively extensive right to preferential tax treatment of contributions.

In *Denmark*, contributions to tax privileged pension schemes are deductible in taxable income at the time of payment. In employer managed schemes, pension contributions are disregarded as part of the wage earner's personal income. This applies to contributions paid to occupational pension schemes (pillar two) as well as contributions paid to individual pension schemes (pillar three).

Yields on pension portfolios are as mentioned taxed with a special pension yield tax of 15%, a rate that can be compared with the highest marginal tax rate of 59% on capital return outside the pension area. Pension payments after retirement are taxed. The yield is taxed according to a market value principle regardless of the type of income. The actual value added is taxed and any loss may be carried forward to future years.

Danish pension taxation can therefore be characterized as an ETT-System. It should be noted, however, that contributions paid to a tax-privileged pension scheme may not be deducted for the purpose of determining the basis on which the Danish labour market contribution of 8% is calculated. If the employer pays contributions to a pension scheme, a labour market contribution of 8% of the pension contribution must be paid. This is offset by the non-payment of labour market contributions on pension benefits.

Contributions paid by an individual to schemes with periodic pension payments until death or schemes with periodic pension payments for at least 10 years are deductible. The taxable value of this follows a progressive scale and is between 39% and 45%, for persons with low incomes, or about 59%. If the employer pays contributions, the employer will not be taxed thereon. Pension benefits paid from such a scheme is subject to tax according to a progressive rate, i.e. between 39% and 45% or about 59% respectively. There is no limit to the amount being deducted, but the deduction must generally be distributed over a 10-year period. If a premium or contribution period is 10 years or longer, deductibility in full is allowed in the year of payment in or payment out. A deduction of up to DKR 42,000 per annum is always allowed (2006 figure).

In 2004 it became possible for self-employed persons to immediately deduct contributions equalling 30% of their profit paid to an annuity scheme and/or regular-premium pension schemes. On cessation of business, it is also possible to pay contributions of up to DKR 2,302,000 (2006 figure), however no more than the taxable profit from the sale of the business.

Employees avoid the rule providing that the tax deduction of contributions to individual pension schemes exceeding DKR 42,000 per annum must be distributed over the following years by agreeing with their employers that the employers pay contributions to the pension schemes of the employees in lieu of remuneration. There is no maximum limit to such contributions and no requirement to distribute the exercise of the right to deduct.

Contributions to capital pension schemes are deductible at a value for tax purposes of 39% to 45%. This also applies to persons with high incomes. It is possible to pay contributions up to DKR 42,000 (2006 figure). Lump sum payments under capital pension schemes are taxed at a special rate of 40%.

Danish law also makes it possible to pay contributions to a non-privileged scheme where the pension benefits are not taxed (TTE). In such cases the yield is taxed as capital income, i.e. at a rate of up to 59%; accordingly, such schemes are hardly ever used.

In case the beneficiary dies before all pension payments under regular-premium pension plans and capital pension schemes have been paid, the spouse or children have inheritance rights. The amounts are subject to an inheritance tax of 15% on top of the 40% disbursement tax. Spouses are, however, exempt from inheritance tax.

In most cases the taxation of pensions in *Finland* follows the EET Principle. This means that pension contributions are deductible, returns on pension funds are tax free before retirement and that pension income is taxable as earned income at progressive rates.

These rules apply to mandatory pensions belonging to the first pillar, and also for the voluntary collective systems belonging to the second pillar.

There are some differences in the taxation of pension and labor income. There is a special pension income exemption which reduces significantly the taxes of those receiving the lowest pensions. Moreover, there are social insurance contributions that only wage earners have to pay.

Occupational pension plans (pillar two) are voluntary, collective, and additional. The employer company signs an additional pension insurance contract with a life insurance company. The employer is entitled to full, unrestricted deductions against income tax for all the costs of contributing to the occupational pension plans. If the lowest retirement age is 60 years, employees have the right to deduct supplementary pension contributions. The ceiling for this deduction is, as a percentage, 5% of the gross wages, and as an amount EUR 5,000 per year. After retirement, the pension benefits from the collective occupational pension plan are regarded as taxable earned income. Occupational pension schemes are rare in Finland.

Taxation of private pension insurance income (pillar three) in Finland is different. Either the employer or the employee can sign an insurance contract for a voluntary retirement pension.

If the employer signs an individual contract for an identifiable wage earner, contributions up to EUR 8,500 per year are – under certain conditions - disregarded as part of the wage earner's personal income. The employer is entitled to full deductions for contributions paid. Pension benefits will be considered taxable earned income.

In 2005, the right to deduct contributions under individual insurance contracts was moved from labour income (with marginal tax rates up to 60%) to capital income (28%) implying a strong reduction in the value of deductibility. The individual is entitled to deduct up to EUR 5,000 per year (the maximum is reduced to EUR 2,500 if the employer has also paid to a voluntary individual pension plan). Under such contracts, pension benefits are taxed as capital income (28%).

As a main rule in Finland, both mandatory and voluntary pension plans follow the principle of reciprocity. Contributions are deductible for the party who pays them, and the benefits are taxable in the hands of the retired person. There are, however, some exceptions. If a private individual arranges for a pension plan involving a one-off payment of contributions to the insurance company, no deduction is given, but the benefits will be taxable. In Finland, an age-based declining schedule gradually reduces the maximum taxable proportion of pension benefits. This gives a strong incentive for using payments under this type of pension plan as late in life as possible.

If the insured person dies before the start of the benefit period or during the benefit period, the heirs of his or her estate will inherit the remaining pension capital of the voluntary pension plans. The tax treatment of payments to the heirs equals that of an inheritance if there is a close family relation. Each beneficiary or heir will not have to pay inheritance tax if the amount is below EUR 35,000.

In *Norway*, the tax treatment of payments under occupational pensions (OPA) and occupational defined contribution schemes (DCA) (i.e. second pillar) is based on the following principles: 1) The employer has the right to deduct contributions paid into the pension plan, 2) the employer's contribution is not considered taxable income in the hands of the employee, 3) the employee may, within certain limits, contribute to the funding of the pension scheme and is in such cases entitled to deductibility, 4) the annual return on the pension portfolio is not taxed and the pension portfolio is not subject to net wealth tax, and 5) the benefits from the pension scheme are taxed as pension income in the hands of the (former) employee.

Under individual pension saving agreements (IPAs) (third pillar), a Norwegian tax payer has up to now been entitled to deduct contributions of up to NOK 40,000 annually. The deduction would have effect upon the computation of the 28% tax on general income only. Payments received from the IPA are taxable as pension income.

The Norwegian Ministry of Finance has, however, in the Revised National Budget 2006, announced that the Government will propose to abolish the preferential tax treatment of pension saving schemes other than the OPA and DCA Schemes. The Ministry of Finance has announced that payments under IPAs made after 12 May 2006 shall not be deductible.

Pension income is subject to taxation at progressive tax rates, with a maximum marginal tax rate of 43%. There is no formal ceiling on deductibility of contributions to an OPA Scheme. However, the benefit regulation (upper limit) in the OPA will in practice establish a ceiling on the contributions. According to the OPA, the regulatory framework shall, as far as the defined-benefit retirement pension is concerned, require a 30 year period of service with the enterprise to qualify for a full pension. Both the OPA and the DCA require a pension plan with annuities either for the rest of the pensioner's life or for a period of at least ten years. The pension cannot be given as a lump sum payment.

According to the OPA, children do not have the right of inheritance to the remaining pension assets in case the pensioner dies. Under a DCA Scheme, the remaining pension assets shall be used for pensions to spouse and children below the age of 21.

Pension taxation in *Sweden* can be characterized as an ETT System. Contributions are deductible, return on pension capital is taxed during the investment period and paid out benefits are generally taxable as personal income at progressive rates.

Both contributions for occupational pensions and contributions to individual private pension schemes are in principle deductible for income tax purposes under certain conditions and within certain limits. Employer contributions to occupational pension schemes are exempt from income tax for the employee.

In order to qualify for privileged tax treatment, the scheme has to comply with both "qualitative" and "quantitative" requirements. One of the qualitative requirements is that the scheme only contains retirement, health and spousal benefits. Retirement benefits and spousal benefits must be paid out during a period of at least five years. It is not possible for a scheme to allow such a benefit in the form of a lump sum payment at a certain time.

Quantitative requirements have the form of thresholds. If contributions exceed those thresholds, they are not deductible. The rules are intended to allow favorable tax treatment only for schemes providing "reasonable" pension benefits.[10] For employers, the main rule is that the contribution may not exceed 35% of the employees' salary nor the equivalent of 10 "base amounts" on a yearly basis. Currently, the base amount is SEK 39,700. For individuals making contributions to private pension schemes, the contribution may, as a main rule, not exceed 0.5 base amounts on a yearly basis.

According to the Swedish Act on Yield Tax on Pension Capital (YTA), the tax is levied at a rate of 15 % on qualified pension capital, and at 27% on unqualified capital. The taxable yield is calculated by multiplying the capital base by the average yield on Swedish state bonds during the year preceding the income year. In contrast to the determination of the taxable base of the yield in Denmark, the actual yield or return does not affect the amount or rate of the yield tax. As the Swedish national reporter observes, the Swedish yield taxation therefore resembles an asset tax or wealth tax rather than an income tax, at least from a technical legal perspective.

Qualified pension insurance policies are exempt from the Swedish wealth tax.

Pension benefits paid under qualified pension insurance policies and schemes are taxable for the retiree/beneficiary as personal income at progressive income tax rates.

After the death of a Swedish pensioner, the spouse and the children are taxed of pension payments according to normal progressive tax rates.

In *Iceland*, pensions are taxed according to the EET tax principle. Contributions are exempt, pension fund returns are exempt while payments of pensions are taxed.

All employees and employers or self-employed persons are obliged to ensure their pension rights through membership of a pension fund from they are 16 years of age until they are 70 years of age (pillar two). The mandatory minimum contribution is 6% of the contribution base. The employee generally pays 4%, while the corresponding contribution from the employer is generally higher than 2% of the total salary.[11]

Employer contributions can be considered a deductible operating expense, provided that the pension funds receiving the contributions operate in accordance with the provisions of the Pension Act. The employer's contribution to the acquisition of employee pension rights is not considered taxable income in the hands of employees.

Individuals have a right to deduct contributions to individual pension schemes (third pillar). The deduction may not exceed 4% of the contribution base. It is a condition for the deduction that contributions are paid on a regular basis.

In Iceland retirement income and pension benefits are considered taxable income at the time they are paid and are taxed at the general tax rate. In the Pension Act it is assumed that contributions will be paid for 40 years and that the pensioner will begin drawing benefits at age 70. In general, however, it is assumed that the drawing of individual

[10] Prop. 1997/98:146 p. 61.

[11] At present there is an Act before the Icelandic Parliament with a proposal for a 12% minimum rate from the year 2007. The general rate is now 11%.

pension savings is permissible from age 60 and concludes at age 67, at which time pension benefits from the social security scheme begin.

Children have the right to children's pension benefits until age 18 upon the death of a member of a joint pension fund. Individual pension savings are inherited. Payments to children shall be divided into equal amounts and be payable until the age of 18. The payments are taxed as ordinary earned income of the child.

4. Balance between mandatory and voluntary pension arrangements, level of public pensions and degree of freedom

In *Denmark*, there are three basic conditions for award of Danish Folkepension (FP), which is the most important part of pillar one in the Danish pension system : The beneficiary shall be a Danish citizen, currently have fixed residence in Denmark and have had fixed residence in the country for at least three years in the age interval 15-65 years. There are certain exceptions from these three basic conditions. People who have had fixed residence in Denmark for at least ten years in the age interval 15-65 years are entitled to FP even when they do not have Danish citizenship. Refugees are also entitled to FP if they have been allowed the right to stay in the country according to §§ 7 and 8 in the Law on Foreigners. Furthermore, the citizenship requirement does not apply to employees and business owners and their family members who are citizens in EU-countries and EEA-countries.

People above the age of 65 holding a Danish citizenship are entitled to FP if they have been residents in Denmark for at least 30 years. This residence requirement does not apply to employees and business owners that have citizenship in another EU-country or an EEA-country. The individual level of FP is determined by the number of years of residence in Denmark. Full pension requires 40 years of residence in the age interval 15-65 years. At the beginning of 2006, the basic FP was DKK 58,032 per year. Pensioners without additional income receive a supplementary pension ranging from DKK 27,276 to DKK 58,416 per year.

Pillar two in the Danish pension system relies both on legislation and on collective agreements between unions and employer associations. All Danish wage earners are members of the mandatory supplementary pension scheme Arbejdsmarkedets Tillægspension (ATP). In 2006, the total assets of ATP represent approximately 17% of the aggregate pension wealth in Denmark In addition, 90% of all employees contribute to occupational pension schemes based on a framework negotiated between the unions and employer associations. The Danish Parliament has since the 1960s facilitated the development of the different pension schemes related to the labor market and this reflects probably the political objective of reducing the future pension burden on the Government budget.

Individual pension schemes under pillar three are used by persons who want to supplement their pension rights under the two first pillars.

In 2002, the Danish Government set up a committee with the aim of proposing arrangements that should allow Danish citizens broader opportunities of choice in their pension schemes. The report of the committee was published in May 2003. [12] The committee recommended introduction of broader opportunities to select pension institution, portfolio manager, better transparency etc. Only a limited number of Danish pension savers have changed pension institution or portfolio managers as a reaction to the institutional changes implemented according to the report.

The most important pension system in *Finland* is the occupational system. It is mandatory and it covers more than 90 per cent of the working age population. There are no pension ceilings in that system and the pensions are not reduced in the case of supplementary income. The mandatory occupational pensions are managed by a group of private sector pension funds (pension insurance companies). Additionally, the state and the municipal sector have their own pension funds. The functioning of these funds is coordinated by the Finnish Center for Pensions. It is a central authority which maintains accounts of individual earnings, contributions, work histories and pension entitlements.

The wide coverage of the mandatory pensions has previously clearly crowded out voluntary pension arrangements. Following an economic crisis in the 1990s, there has been an increasing demand for additional private pension insurance schemes.

In *Norway*, the foundation of the old age pension system is the pension scheme under the National Insurance Scheme (NIS). The NIS basic pension is in 2006 NOK 62,892. This amount (called “G”) is increased every year in accordance with the growth in average wages. The NIS basic pension is based on the number of years of insurance, usually the number of years a person has had residence in Norway. For persons with less than 40 years of residence, the pensions are reduced proportionally. On top of the NIS basic pension, people can receive additional pension based on their history of taxable income that gives pension rights. Capital income does not give pension rights. A person acquires pension points for the amount of earned income, measured in “G”, that exceeds one G. Earned income above six G only count for a third of income in the interval 1-6 G and earned income in excess of 12 G does not count at all. The pension points used for calculating additional pension is based on the average of the best 20 years with penion points.

The public occupational pension schemes are based on different principles than the NIS. The schemes cover practically every employee in the public sector. Given full coverage, which requires 30 years of employment in the public sector, the gross compensation rate is 66% of the income at the end of the career. For most of the employees, the public occupational pension scheme has the same pension age as the NIS pension scheme.

The private occupational scheme in Norway is described briefly in section 1 above. From 2006, private occupational pension schemes are mandatory.

[12] *Større Valgfrihed i Pensionsopsparingen,* (More freedom of choice in pension saving), Økonomi- og Erhvervsministeriet, Beskæftigelsesministeriet, Finansministeriet og Skatteministeriet, København Maj, 2003.

The pension system in *Sweden* rests on three pillars: Social security, mandatory occupational pension schemes and private life insurance. Since the enactment of a new social security pension system in 1999, pillar one has consisted of two parallel pension systems. A gradual transition is going on.

The old system consists of a flat rate no means-tested, defined benefit scheme, the national basic pension scheme (FP) and an additional income-related national supplementary pension scheme (ATP). ATP was a PAYG system financed by pay-roll taxes on earnings. In the pre-reform system, the FP together with the earnings related benefit provided a gross replacement rate of about 65% of the earnings of an average Swedish worker.

The new system consists of two defined contribution systems. A Notional Defined Contribution system (NDC) and a funded defined contribution system (DC). The NDC scheme was explained in section one above. The new system has a guarantee minimum pension for people without any or low income from employment. The contribution rate is 18,5% of earnings up to a certain level. 16% go to the NDC system and the remaining 2,5% to the DC system. An individual can choose to invest his or her contributions to the DC system in one to five out of 500 registered funds. For those who do not choose funds actively, the contributions are invested in a default fund.

Pillar two consists of private employer-based occupational pensions. There is an ITP-plan for salaried employees and a STP-plan for wage earners. The ITP-plan includes both a DB and a DC component. In year 2000, the STP-plan was changed by a new DC-system under which employers contribute 3,5% of the earnings to an individual account for the employee. The individual is then free to choose from a number of different pension providers and investment plans.

The third pillar covers the private pension schemes.

The social security system in *Iceland* (pillar one) was founded in 1936 with the main purpose of ensuring the livelihood of those unable to work because of age or disability. A person must have lived in the country for at least 40 years before he or she can enjoy full benefits. The system provides old age pension, disability pension, sickness, maternity and survivors pension. In most cases the old age pension is paid from the age of 67. The pension is paid in basic flat-rate payments and supplementary additions to single or low income people. The basic pension is low or roughly 10 % of the average earning of unskilled workers. The main transfers are through the supplementary pension. When a beneficiary has income above a certain threshold due to other income sources, the supplementary pension is reduced.

The public pension system in Iceland is fully financed by taxes. The main financing source is the social security tax which is earmarked to the social security system. The social security tax rate is in 2006 5,73% and the tax base is total salaries. The tax is paid by the employers.

Pillar two in the Icelandic pension system is occupational pension funds. These funds must fulfill a number of requirements in order to receive mandatory contributions. The first part of the contributions go towards acquiring basic pension rights which, for a 40 year period of contributions, should give a life-long pension amounting to at least 56% of wages during the contribution period. The second part can go towards acquiring additional pension rights including defined contribution schemes with individual accounts. The Internal Tax Directorate is the supervisor of the mandatory payment of contributions. The main rule is that members can begin to withdraw old-age pensions at the age of 67.

Pension payments from the occupational pension system in Iceland are expected to increase in the years to come while the expenditures of the social security system in form of pension payments due to means-testing will diminish. Pension payments under pillar two will gradually replace pension payments under pillar one.

5. Issues of fiscal sustainability

Exhibit 5 gives a rough overview of public balance and and gross public debt as a percentage of GDP in the Nordic countries at the end of 2005.

Exhibit 5: Public balance and General Government Debt as percentage of GDP in the Nordic countries at the end of 2005

	Public balance (net borrowing/lending of consolidated general government sector % of GDP)	General Government Debt Consolidated gross debt % of GDP.
DK	+ 4,9%	35,8%
FI	+ 2,6%	41,1%
NO(2004)	+ 11,5%	46,5%
SW	+ 2,9%	50,3%
IC	+ 5,6%	36,8%

Source: Eurostat and Icelandic National report. .

In *Denmark*, there is - and has for some years been - a considerable Government budget surplus. As documented in Exhibit 5, in 2005 the Danish surplus corresponded to 4.9% of GDP. Consequently, the gross debt of the Government has been declining and is in 2006 approximately 30% of GDP. Long-term projections published by the Commission on Welfare shows that the combination of increasing life expectancy, declining tax revenue from oil production in the North Sea and relatively low fertility rates will put pressure on the Government budget from 2025 and onwards.

The conclusion is that in Denmark there is no concern regarding fiscal sustainability due to ageing in the short-term. In the long-term, however, when the old-age dependency ratio has increased, there are reasons to be concerned. Recent initiatives to increase the effective retirement age should be understood in this perspective.

The current fiscal position of the public sector in *Finland* is relatively strong. In 2005, the surplus on the consolidated Government budget corresponded to 2.6% of GDP. In the medium term, the public sector is expected to maintain its finances in surplus. In the longer term, pension expenditures consisting of mandatory occupational pensions and basic state pensions are expected to increase to a level of 10-11 per cent of GDP. The gross public debt represents in 2006 about 40% of GDP. Due to forecasted budget surpluses, that figure is expected to decrease to less than 30% by 2010. The Finnish public sector does not have any net debt. Mainly due to the funds of the mandatory pension system (corresponding to 65% of GDP), the public sector has large net assets.

The conclusion is that in Finland there is no concern regarding fiscal sustainability due to ageing.

The short-term fiscal situation for the Government in *Norway* is healthy. In 2004, the Government surplus corresponded to 11.5% of GDP which is by far the largest surplus figure in Exhibit 5. Large revenues from the petroleum sector ensure that sustainability issues are of minor importance. Revenues from the petroleum sector of today's level are not expected to continue for a long time and the old-age dependency ratio is expected to increase.

The gross debt of the Norwegian Government corresponded in 2004 to 46.5% of GDP, but the public sector in Norway is a net creditor. The main part of the Norwegian Government's financial assets is organized through the State Pension Fund.

The conclusion is that in Norway there is no concern regarding fiscal sustainability due to ageing in the short term. The long-term effects of ageing on fiscal sustainability are addressed in the ongoing pension reform process.

In *Sweden*, there was in 2005 a surplus on the consolidated Government budget corresponding to 2.9% of GDP. At the end of 2005, the general Government gross debt represented 50.3% of GDP, the highest percentage in the Nordic area. In Sweden concerns in the 1990s about the sustainability of the pension system motivated a fundamental reform implemented in 1998. Before the reform, both pension benefits and earned pension rights were indexed to follow prices. The driving force behind the reform was the threat that the pre-reform system could not be financed in the future.[13]

To deal with potential problems regarding fiscal sustainability, the Swedish reform introduced an automatic balancing mechanism. Whenever automatic balancing must be applied, per capita wage indexation of earned pension rights and current benefits is reduced to bring the system back in balance. Thus, all adjustments to maintain stability take place on the benefit side. The robustness of the system is strengthened by means of buffer funds that will cover projected deficits in benefit financing when needed.

With the introduction of the new pension system, there is no concern regarding the fiscal sustainability due to ageing in Sweden.

The development of the Central Government's finances in *Iceland* has been positive in most respects over the past decade. In the year 2005, there was a considerable surplus corresponding to 5.6% of GDP. For the years 2006 and 2007, somewhat lower surpluses are expected: 4% for 2006 and 1.5% of GDP for 2007. A forecast of the Government budget balance for the year 2008 shows a slight deficit of 0.5% of GDP. The increase in expenditures on old-age pensions is under discussion between the Government and the Icelandic pension funds.

6. International mobility of labour and capital

Free movement of people and capital has strong implications for tax systems. During their employment period, thousands of income earners have jobs in several countries. They may choose to move from one Nordic country to another but they may also seek work in other European countries or overseas. People may also prefer to enjoy their pension rights in a country different from the country in which they have saved for retirement. People have of course an interest in preserving their pension rights regardless of in which country they have earned their income and paid their pension contributions. Pension providers compete in order to attract customers. It is natural that the customers want to choose the pension provider that offers the highest (safe) return on the pension portfolio after tax. In the Nordic countries, individuals can choose pension arrangements that allow them to have portfolios with a mix of domestic and foreign bonds and shares.

Pension schemes falling within pillar I (statutory social security contributions) give rise to a number of special problems that relate to the interpretation of Regulation 1408/71. The summary analysis in this chapter is limited to pension schemes falling within pillar II (occupational pension schemes) and pillar III (individual pension schemes).

Contributions to foreign pension institutions

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[13] Sundén, op.cit. p. 137. The new Swedish pension system and Notional Defined Contribution schemes are described above.

All Nordic countries generally give contributions paid to *domestic* pension schemes a privileged tax treatment. The privilege involves deductibility at the time of payment to the person making the contribution and – if the employer pays the contribution – further tax exemption to the employee for the contribution paid by the employer.

It is still an unsettled question whether it follows from the provisions on freedom of movement in the EC Treaty and the corresponding provisions in the EEA Agreement that individual Member States must subject contributions to a foreign pension scheme to privileged tax treatment.

In its judgment in the Bachmann case from 1992, the European Court of Justice (ECJ) first addressed the question whether it was contrary to the provisions of the EC Treaty governing the free movement of workers and services to refuse to allow deduction for payments into *foreign* pension schemes.[14] According to the ECJ, the Belgian rules were not contrary to the provisions of the EC Treaty, as the Court found that the hidden discrimination was justified by the need to preserve the cohesion of the tax system. This cohesion was ensured by a connection between the deductibility of contributions and the liability to pay tax of payments out etc. under the schemes, when at the same time payments out etc. under such schemes are exempt from tax when there has been no deduction of contributions (paragraph 21 et seq.).

However, since the decision in *Bachmann* the ECJ has, in several of its judgments, held that national pension rules are contrary to the provisions of the EC Treaty.[15]

In a Communication from 2001,[16] the Commission argued that the need to ensure the cohesion of the tax system cannot justify the failure to allow tax deductions and tax exemptions for payments into foreign pension schemes.

Since 2001, the Commission has contacted several Member States with a view to increasing the right to privileged tax treatment of payments in, so as to allow deductibility for contributions to schemes in other Member States. Similarly the EFTA Surveillance Authority has contacted EFTA Member States, for instance Iceland, concerning this problem referring to the corresponding principles of freedom of movement in the EEA Agreement. In the case of the *Commission against Denmark* (Case C-250/04), Advocate General Stix-Hackl has recommended in her Opinion of 1 June 2006 that the ECJ should hold that the Danish rules are contrary to the principles of freedom of movement in Articles 39, 43 and 49 of the EC Treaty.

Of the Nordic countries *Finland* and *Iceland* – referring to the principles of freedom of movement – have made it possible to give privileged tax treatment to payments into a foreign pension scheme. *Denmark* and *Sweden* await the decision of the ECJ in the case against Denmark (Case C-250/04), whereas legislators in *Norway* intend – in respect of individual pension schemes – to abolish the tax privilege accorded to contributions to both domestic and foreign pension schemes.

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[14] Judgment of 28 January 1992 in Case C-204/90 *Bachmann* [1992] ECR I-249.

[15] See e.g. Judgment of 11 August 1995 in Case C-80/94 *Wielockx*, Judgment of 3 October 2002 in Case C-136/00 *Danner*, Judgment of 26 June 2003 in Case C-422/01 *Skandia*. See also Judgment of 28 April 1998 in Case C-118/96 *Safir*.

[16] COM(2001) 214.

Finland affords the best possibilities of privileged tax treatment of contributions to foreign pension schemes. In its decision in *Danner* (Case C-136/00) in 2002 the ECJ held that the former Finnish tax laws were contrary to the freedom to provide services. Consequently, Finnish legislation was amended. The tax rules stipulate that tax benefits are given for the payment of contributions to a pension institution identifiable as a taxable person in the EU/EEA. Moreover, deductions are given for the payment of contributions to a pension institution with a permanent establishment in one of the member states of the EU/EEA. Exactly the same principles and rules as govern the deductibility of contributions in Finland are applicable to the EU/EEA contributions. This applies to both contributions to occupational pension schemes and contributions to individual pension schemes.

In *Iceland*, all pension funds that receive contributions from employed persons in Iceland must have a license from the Ministry of Finance and fulfil obligations that are stated in the Pension Act, no.129/1997. Although all pension funds that operate the mandatory pension scheme, are monitored by the Financial Supervisory Authority in Iceland, there is nothing in the pension act that prohibits the pension funds to be located and operate from abroad. A foreign pension fund fulfilling the conditions stipulated in the Icelandic Pension Act could therefore accept contributions from employers in Iceland giving the same tax treatment as contributions paid to a domestic pension fund.

If a pension fund operates a voluntary pension scheme, it is not required to be situated in Iceland if it fulfils requirements stipulated in the Pension Act. The requirements are that these pension funds be established and licensed in another state of the EEA or member state of the EFTA treaty. This also applies to commercial banks, savings banks , and securities undertakings and life insurance companies.

Domestic institutions are obliged to inform the Icelandic tax authorities about both mandatory and voluntary pension contributions. The same documentation requirements apply concerning contributions to foreign pension schemes if the employee demands deductibility in his taxable income in Iceland.

In *Norway*, contributions to individual pension schemes must be made to a financial institution authorised to operate in Norway or to a Norwegian branch of a financial institution established within the EEA. This requirement must be met whether or not the pension plan was established before or after the person in question moved to Norway. If this requirement is not met, the contribution will not be deductible. However, the Ministry of Finance has, in the Revised National Budget for 2006, announced that the Government will propose to abolish the preferential tax treatment of individual pension schemes, and contributions to an individual pension scheme set up after 12 May 2006 shall not be deductible at all.

For occupational pension schemes the pension institution must be established in Norway. A foreign occupational scheme will in practice be regarded as a group pension scheme outside the tax privileged pension schemes. The employer has no right to deduct the contributions paid to such schemes. However, the employer’s contribution will not be considered taxable income for the employee. Contributions paid by the employee to such a scheme will not be deductible.

Both *Denmark* and *Sweden* give tax privileged treatment to contributions to pension schemes – domestic occupational pension schemes as well as domestic private pension schemes. The tax privilege does not extend to foreign pension institutions unless they have established a branch in Sweden or Denmark.

Exhibit 6 Tax treatment of cross-border pension contributions in the Nordic countries:

Tax benefits – contributions

	Pillar II Occupational pension schemes			**Pillar III Individual pension schemes**		
	National	**Foreign**	**PE of foreign**	**National**	**Foreign**	**PE of foreign**
Denmark	Yes	No	Yes	Yes	No	Yes
Finland	Yes	Yes	Yes	Yes	Yes	Yes
Norway	Yes	No	Yes	Yes (From May 12 2006: NO)	No	Yes (From May 12 2006: NO)
Sweden	Yes	No	Yes	Yes	No	Yes
Iceland	Yes	No	??	Yes	Yes	Yes

All Nordic countries, except Iceland (concerning contributions to occupational pension schemes), also give preferential tax treatment to contributions paid to pension schemes established with the permanent establishment of a foreign EU/EEA pension institution.

Tax incentives to persons moving to a state on contributions to schemes in the state of origin

Special consideration may have to be given to persons who move from one country to another. Such persons will often already belong to a pension scheme in their state of origin. In its Communication from 2001 the Commission stated: “In the case of citizens who already belong to a scheme approved for tax purposes in their home State and then move, often temporarily, to another Member State, the host State cannot refuse to grant tax deduction of contributions paid to the foreign scheme on the ground that the scheme does not meet its conditions for tax approval."[17]

In *Finland*, *Iceland* and *Sweden* special rules of domestic law ensure the right of persons moving to those countries to privileged tax treatment if they continue to pay contributions to a pension scheme in the state of origin whether this scheme meet the same conditions as national pension schemes or not.

As mentioned above, *Finland* generally gives privileged tax treatment to contributions paid to a foreign scheme. Exemption may also be granted to persons who move to Finland from a country outside the EU/EEA (In that case tax exemption may be granted for three years). However, exactly the same conditions as under tax privileged domestic pension schemes must be fulfilled.

The Finnish national reporters make the following comment on the possibility of tax exemption regarding foreign pension schemes: "Exactly the same principles and rules as govern the deductibility of contributions in Finland are applicable to the EU/EEA contributions."

In *Iceland* employees from the EU/EEA are guaranteed the right to continue contributing to a foreign pension scheme with privileged tax treatment that is intended for supplementary pension savings.

In contrast, *Sweden* does not generally give privileged tax treatment to contributions paid to a foreign scheme. On certain conditions, domestic tax law gives persons who have moved to Sweden privileged tax treatment regarding contributions paid to an existing pension scheme in another country. In the case where an individual has acquired a non-Swedish life insurance policy for mainly retirement, health or spousal benefits while domiciled outside Sweden, the policy is recognized as qualified pension insurance, provided that the individual obtained privileged tax treatment for the policy abroad. The same applies to a non-Swedish occupational pension insurance policy acquired during residency or service outside Sweden provided that the insured person, i.e. the employee, has not been taxed for the benefit in the jurisdiction concerned. In addition, the Swedish Tax Agency may on application designate a non-Swedish insurance policy as qualified pension insurance in cases of "compelling reasons". The reason for this rule is mainly to enable foreign workers active in Sweden to maintain existing pension arrangements.

Neither *Danish* nor *Norwegian* domestic law gives privileged tax treatment to persons who move to these countries regarding contributions paid to existing pension schemes in the state of origin.

The OECD Commentary on Article 18 of the OECD Model contains suggestions that may ensure privileged tax treatment to contributions paid to a foreign scheme for persons who move from one country to another.[18] The only Nordic countries that have included provisions addressing this issue in their double-taxation treaties are *Sweden* and *Denmark*, but only in few treaties and provided that certain conditions are met. *Sweden* has included such provisions in its treaties with Denmark, France, the Netherlands and the USA. *Denmark* has – in addition to its treaty with Sweden – included such provisions

[17] COM(2001) 214, section 3.7.

[18] OECD Commentary (2005-versionen) on Art. 18, paragraph 37 et seq.

in double-taxation treaties with Switzerland, the United Kingdom and the Netherlands. In contrast, neither *Finland, Norway* nor *Iceland* has included such provisions in any of their double-taxation treaties.

The treaty between *Denmark* and *Sweden* provides that, in a situation where a person works or carries on commercial activities in the state of residence, privileged tax treatment may only be granted on the condition that the contributions are paid to a pension scheme in the other Contracting State. It is also a condition that the person concerned paid contributions to the pension scheme in the state of origin immediately prior to becoming resident in the other Contracting State.[19] The treaty between Denmark and Sweden does not govern pension schemes established in third countries, nor does it govern situations where, prior to moving his residence, the person has suspended the payment of contributions to the pension scheme. Moreover, the treaty only applies to contributions paid to certain pension schemes. If a tax deduction is subject to a maximum amount in one or both countries, the tax deduction may not exceed the lower amount; see Article 2(2). The treaty governs contributions paid to both occupational pension schemes and individual pension schemes.

The tax treatment of pension portfolio return (yield taxation)

Finland, *Iceland* and *Norway* do not subject tax-privileged pension schemes to yield taxation. The rules of taxation in these countries are based on the EET tax principle (Exempt contributions, Exempt yield of the pension institutions, Taxed pension benefits). Tax exemption concerning the current yield also extends to foreign schemes.

Payment of benefits made from domestic and foreign pension schemes are taxed, and relief is granted for any tax paid in another country under double-taxation treaties or domestic rules. The *Finnish* reporter observes that only the amount net of the foreign yield tax is considered pension income, and that no credit relief is granted for the foreign yield tax paid.

The fact that pension benefit plus the yield from a tax-privileged pension scheme is taxed when the payment of the benefit is made cannot reasonably be considered real taxation of the yield. The reason is that, due to the tax benefits of contributions to the scheme, larger sums may be paid into the schemes. Or as the Norwegian national reporters put it: “The deferral of the taxation of the pension rights from the time of accrual of the pension rights to the time of payment, will in practice give the same net (after tax) amount as if the pension right was taxed at the time of accrual, and the yield was not subject to any tax at all. Thus, it may be argued that the effective tax rate of the capital income from most pension portfolios is zero.”[20]

Both *Denmark* and *Sweden* have yield taxation.

In *Sweden* the beneficial tax treatment consists of deductibility for contributions, which applies to occupational pension schemes as well as individual pension schemes, deferral

[19] See Art. 2(3)(b) of the Cross-border Commuters Agreement with Sweden of 29 October 2003, implemented in Denmark by Act no. 974 of 5 December 2003, cf. Executive Order no. 36 of 28 October 2004.

[20] See the Norwegian national report, section 3.4.

of income tax, a lower yield tax charge and exemption from wealth tax. Life insurance policies issued by non-Swedish institutions with no PE in Sweden and held by Swedish persons, whether individuals or others, are also subject to yield tax. The legal tax payer in this case is not the non-Swedish institution but the policyholder. This means that the policyholder, typically an employer or an individual, must disclose the amount taxable attributable to a non-Swedish life insurance policy in the yearly tax return. Furthermore, the method for calculating the taxable deemed yield is also different for non-Swedish policies, but the yield tax rate is – since an amendment in 2004 - the same (15%).[21]

The general yield tax rate on tax-privileged pension schemes in *Denmark* is 15%. The yield of non-privileged pension schemes is generally taxed as capital income, i.e. up to 59%. As indicated above, only schemes established in Denmark are tax-privileged. In practice persons in Denmark who establish a pension scheme in another country will always be subject to tax up to 59% of the yield (which is the reason why such schemes are not established in practice). This difference must probably be deemed contrary to the freedom to provide services.

However, an important exception to this rule applies to persons who move to Denmark. The yield is tax exempt in Denmark if the foreign pension scheme was established at a time when the person concerned was not resident in Denmark and all contributions paid to the pension scheme enjoyed preferential tax treatment before the person became a Danish resident. If the condition of preferential tax treatment in the state of origin is not met, the yield is taxed as capital income, i.e. up to 59%.

Taxation of cross-border pension to a person resident in another state

All the Nordic countries except Norway have rules on withholding tax on pension benefits to a person resident in another country. However, the Norwegian reporters observe that the situation may change in the foreseeable future, as the Ministry of Finance is working on a proposal which will make pension payments to non-residents subject to Norwegian withholding tax.

In *Sweden* payments from a Swedish pension institution are subject to tax at a flat rate of 25% and no deductions are allowed. The person is taxed for occupational pension payments provided that the pension is attributable to former employment in Sweden and that the operations were mainly conducted in Sweden. Only pension payments made under qualified schemes are subject to tax, which is logical since contributions to unqualified schemes generally are non-deductible for income tax purposes.

In *Denmark* and *Finland* pension benefits subject to limited taxation are generally taxed in the same way as earned income, i.e. at a progressive tax rate.

In *Finland* pension benefits in the hands of non-residents are taxable as earned income as of the 2006 taxable year and will be taxed according to the progressive scale. No importance is attached to the question whether the contributions had been deductible in

[21] Previously, the "non-Swedish" pension capital was subject to the higher yield tax rate, i.e. 27% and not 15%. The Swedish Supreme Administrative Court ruled that the difference in treatment for yield tax purposes constituted a restriction to the freedom to provide services, RÅ 2004 ref. 84.

Finland, and whether they were indeed deducted in Finland, and whether the recipient of the pension benefits had previously been a tax resident in Finland.

In *Denmark* non-residents are generally subject to the same level of taxation of their pension benefits from Denmark as residents, i.e. in most cases at a progressive tax rate. Only expenses related to the income of the non-resident may generally be deducted unless the person concerned derives at least 75% of his income from Denmark. If pension benefits are paid from foreign schemes that are not subject to privileged tax treatment, the benefits are tax exempt. Yield taxation (15%) is paid by the pension institution and the yield on a tax-privileged scheme is also subject to tax whether or not the pension saver is subject to Danish tax. Consequently non-residents are subject to higher tax of the yield on a tax-privileged scheme in Denmark than of the yield on free savings.

According to the OECD model convention, private pensions paid in consideration of past employment shall be taxable only in the state of residence. However, in treaty negotiations *Iceland, Norway*, *Sweden*, *Finland* and *Denmark* seek to establish a right for the state of source to levy withholding tax on all pensions, private as well as public.

The Nordic double-taxation treaty confers the right to tax to the state of source and the provisions of Articles 18 and 19 are drafted in such a way that the state of residence must grant relief under the exemption method. Taxation in the state of source reduces the attractiveness of leaving the country for another country with lower taxes and ensures taxation in the state that granted tax exemption when the contributions to the scheme were paid.

However, all the Nordic countries still have double-taxation treaties that confer the right to tax according to the OECD Model so that the state of residence has the right to tax pension benefits (except pension benefits paid by the contracting states, see Art. 19(2)). For instance, none of the Nordic countries has been able to convince France to confer to the state of source the right to tax pension benefits governed by Art. 18.

Exit taxes in cases of moving to another country

Denmark is the only Nordic country that subjects pensions to exit tax. The Danish exit tax applies to schemes where, within the last 5 years (10 years for principal shareholders), an employer has paid exceptionally large contributions to a tax-privileged pension scheme. When contributions exceed 20% of total earned income from the employer concerned, the person moving to another country will subsequently be subject to tax.

The Danish exit tax is a result of Danish law conferring on the employer an extensive right to agree with the employee to pay contributions (without a prescribed maximum limit) to a tax-privileged pension scheme in lieu of wages or salary. The employee will not have to pay tax on the contributions to the pension scheme, and the employer is allowed to deduct the contributions in full. If a person later moves to, for instance, France or Spain the applicable double-taxation treaties preclude Denmark from levying tax on the pension benefits paid from Denmark. It is possible to grant an exemption from the exit tax, but it is debatable whether the exit tax complies with the principle of freedom of movement.

Frontier workers (cross-border commuters)

When a person works or carries on business from a permanent establishment situated in a country other than the state of residence, Articles 7 and 15 of both the OECD Model and the Nordic double-taxation treaty provide that the right to tax the income is generally conferred on the state of source, whereas the state of residence has to grant relief.

The Nordic double-taxation treaty generally provides that the rules of domestic law in the Nordic countries shall determine whether or not privileged tax treatment will be granted to contributions paid to a pension scheme (however, see the discussion of the 2003 treaty between Denmark and Sweden below). This corresponds to the provisions in the OECD Model. However, judgments by the ECJ show that the principles of freedom of movement may result in a duty to grant privileged tax treatment.

All the Nordic countries have rules that, to a large extent, give privileged tax treatment to non-residents concerning their contributions to a *domestic* pension scheme (i.e. in the state of source). However, only *Finland* and *Iceland* have domestic rules that provide for privileged tax treatment on contributions to a foreign scheme, including the state of residence of cross-border commuters.

The main reason for this is that, as a general rule, the Nordic countries allow non-residents the same privileges as residents. As an exception, however, *Denmark* and *Finland* only allow a non-resident to exercise a right to deduct contributions paid to an individual pension scheme if the taxpayer derives at least 75% of his income from the state of source.

In *Finland* employers with limited tax liability generally pay tax at source, withheld on payment at the rate of 35%. In such cases no privileged tax treatment of individual pension schemes is granted. If he derives at least 75% of his income from Finland or an EU/EEA country, a non-resident may be subject to pay tax on his contributions to pension schemes under the same rules as residents. As already mentioned, Finland grants privileged tax treatment to contributions paid to foreign pension schemes.

In *Sweden* non-residents employers with limited tax liability generally pay tax at source (SINK), withheld on payment at the rate of 25%. In such cases no privileged tax treatment of pension schemes is granted.

In *Iceland* non-residents have the same right to tax privileges on contributions to pension schemes as residents. Furthermore, Iceland has introduced rules based on Council Directive 98/49/EC that extensively allow tax privileges for contributions paid to a foreign pension scheme.

In *Norway* contributions paid to an occupational pension scheme and an individual pension scheme of a non-resident in Norway are granted the same tax privileges as residents. In practice, no tax privileges may be enjoyed for contributions paid to a pension scheme in another country.

In *Denmark* privileged tax treatment is granted to an employer who pays contributions to a pension scheme (i.e. deductibility for the employer and tax exemption for the employee). In contrast, a non-resident does not generally enjoy tax privileges on his own contributions to an individual pension scheme. If he derives 75% of his income from Denmark, the taxpayer concerned may elect to be taxed on a par with residents, thereby being able to deduct his contributions to an individual pension scheme.

Article 2 of the Cross-border Commuter Agreement between *Denmark* and *Sweden* from 2003 provides that persons resident in Denmark and who work or carry on business in Sweden may be granted deductibility in Sweden for contributions paid to Danish pension schemes (and similarly for persons who are resident in Sweden and who work or carry on business in Denmark and have pension schemes in Sweden). It is a condition for such deductibility that the person concerned derives at least 75% of his total income from the state of source.[22]

All the Nordic countries apparently allow tax privileges to be enjoyed for contributions paid to a domestic pension scheme (i.e. in the state of residence) under general rules, even though the person concerned works or carries on business in another country. In order to obtain preferential tax treatment in the state of residence the existence of income taxed in that country is often required. If contributions are paid to a pension scheme in the state of source, only *Finland* and *Iceland* grant tax privileges.

Pension taxation and freedom of movement

The principles of freedom of movement have greatly affected the wording of the rules governing pension taxation in the Nordic countries and will – most likely – lead to substantial changes in the years to come.

At present, the ECJ has addressed national rules on pension taxation in *Finland* (Case C-136/00 *Danner*) and *Sweden* (Case C 118/96 *Safir*; and Case C-422/01 *Skandia*). In all these cased the national tax rules were held to be contrary to the principles of freedom of movement. Furthermore, on 1 June 2006 Advocate General Sticx-Hackl observed in her Opinion that the Danish pension tax rules are contrary to the principles of freedom of movement because they do not grant tax privileges for contributions paid to foreign pension schemes.

The most extensive amendments have so far been adopted by *Finland*. They were adopted as a result of the judgment by the ECJ in *Danner* (Case C-136/00) from 2002. According to the judgment the former Finnish rules that restricted or disallowed deductibility of contributions to voluntary pension schemes paid to pension providers in other Member States constituted a restriction of the freedom to provide services. Following the changes of the Finnish pension tax rules in 2005, the same principles and rules as govern the deductibility of contributions in Finland are applicable to EU/EEA contributions.

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[22] See Art. 2(3)(a), of the Cross-border Commuters Agreement with Sweden of 29 October 2003, implemented in Denmark by Act no. 974 of 5 December 2003, cf. Executive Order no. 36 of 28 October 2004; in Sweden: SS 2004:639, prop. 2003/04, bet. 2003/04:SkU31.

Furthermore, as from 2006 Finland has changed its rules governing limited tax liability so that income is taxed according to general rules at progressive tax rates. The amendment is a result of the need to comply with EU law. A case concerning the former rules is pending before the ECJ; see Case C-520/04 *Turpeinen*. In his Opinion of 18 May 2006 Advocate General Leger recommends that the Court should hold that the former Finnish rules are contrary to Article 18 of the EC Treaty (Union citizenship).

In *Safir* (Case C-118/96), the special premium tax that *Sweden* previously levied on non-Swedish life insurance policies was found to restrict the freedom to provide services. The special premium tax was subsequently abolished.

In *Skandia* (Case C-422/01), the ECJ held that the Swedish tax treatment of the employer's contributions to non-Swedish occupational pension insurance policies did not comply with the freedom to provide services. According to the Swedish tax law such contributions were not deductible "as pension costs". [23] Sweden has not at present amended its tax law as a consequence of the Skandia case. In a subsequent case before the Swedish Supreme Administrative Court, the court upheld the establishment requirement for income tax purposes with regard to individual private pension insurance policies citing *Bachmann*.[24] On 20 December 2004, the Commission resolved to send a reasoned opinion to the Swedish government requesting that Sweden amend its allegedly discriminatory pension tax legislation.[25]

In 2004 *Norwegian* legislators passed an act providing that life insurance companies domiciled in another EEA country should be permitted to offer occupational pension schemes without having to set up a branch in Norway. The proposal implied that schemes offered by such companies shall enjoy the same tax treatment as pension schemes established with insurance companies having a permanent establishment in Norway. The act has not yet come into effect.

In *Iceland*, a person resident in Iceland enjoys equal possibilities of tax-privileged pension contributions to domestic and foreign pension institutions. This non-discrimination derives from an amendment in 2004 to the Pension Act and was adopted by the Icelandic Parliament in order to address concerns raised by the EFTA Surveillance Authority on the compatibility of the previous provisions.

In *Denmark* the pension tax rules were amended in 1992 and 1998 with a view to making the rules compatible with EU law. These amendments resulted in reciprocity so that privileged tax treatment of contributions is balanced by taxation of pension benefits, whereas tax exemption for contributions is balanced by tax exemption for pension benefits. Danish law does not limit or grant privileged tax treatment to contributions paid to a foreign pension scheme.

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[23] The Swedish national reporter observes that the ECJ appears to have rendered its ruling under the somewhat misleading impression that employer contributions to non-Swedish schemes are not deductible at all under Swedish tax law. The contributions in this case were most likely deductible, albeit the uncertainty whether the cost is of pension or salary nature remains. The Swedish Supreme Administrative Court subsequently ruled that community law entitled Skandia to deduct the premiums, see RÅ 2004 ref. 28. See the Swedish national report section 6.6.1.

[24] RÅ 2004 ref. 84.

[25] See the Commission's press release IP/04/1500.

Consequences of the Danish pension tax case

In the case the *Commission against Denmark*, Case 250/04, Advocate General Stix-Hackl recommends in her Opinion of 1 June 2006, as mentioned above, that the ECJ should hold that the Danish rules are contrary to the principles of freedom of movement enshrined in Articles 39, 43 and 49 of the EC Treaty. Sweden has joined the case to support Denmark.

If, in the Danish pension tax case (Case C 250/04), the ECJ holds that it is contrary to the provisions of the EC Treaty governing the fundamental freedoms to refuse to allow deductions for payments into foreign pension schemes when deductions are granted for payments into Danish schemes, this will result in additional problems for Denmark.[26]

Firstly, there will be an increased risk that Denmark will have to waive the right to tax payments from pension schemes even though Denmark has previously granted deductions for contributions.

If a person, with reference to EU law, is entitled to deductions for payments into a foreign scheme, he may avoid paying Danish tax by moving to another country before the pension benefits become payable. This problem already occurs today when a person moves from Denmark to, for instance, Spain or France as a result of the existing double-taxation treaties, but the problem will be extended to cover every situation where a person moves from Denmark to another country before pension benefits become payable. The *Finnish* and *Swedish* reporters observe that one of the problems of privileged tax treatment of contributions paid to a foreign scheme is that it is doubtful whether it will be possible to tax at source when the pension benefits are paid by a pension institution in another country to a non-resident. It creates a particular problem if a person who is resident in another country for a short period is granted tax exemption for all his benefits even though he enjoyed tax privileges when paying his contributions to the pension scheme.

This problem seems to exist today in *Finland* and *Iceland* and will, if the ECJ rules against Denmark, also appear in the other Nordic countries.

The countries could consider introducing a tax imposed when the taxpayer moves his tax residence abroad in order to solve the problem, but such a tax may be contrary to the provisions of the EC Treaty; see the judgment in *de Lasteyrie du Saillant*.[27]

Another solution to the problem in relation to EU law may be to abolish deductions for payments into the schemes, i.e. change to a system that generally has only TE schemes without the tax deferral. Danish economists have supported such a solution,[28] but Danish politicians have so far decided to maintain tax deductions and tax exemptions for pension schemes. As mentioned above, the Ministry of Finance in *Norway* has announced that the Government will propose to abolish the preferential tax treatment of individual pension schemes.

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[26] Niels Winther-Sørensen in Michael Lang, Josef Schuch and Claus Staringer (eds.): ECJ-Recent Developments in Direct Taxation, p. xxx.

[27] Judgment of 11 March 2004 in Case C-9/02 *Hughes de Lasteyrie du Saillant* [2004] ECR I-2409.

[28] See e.g. Det økonomiske Råd: Dansk Økonomi, spring 2001, p. 174 et seq.

Secondly, it is necessary to resolve the problem how the pension yield tax can be maintained. The tax sums involved are in reality paid by the Danish pension institutions. It will not be possible to require foreign pension institutions to pay in the tax. One solution could be to require the individual policyholder to pay the tax relating to his pension scheme. Such a solution is now found in *Sweden* but only in respect of foreign pension schemes.[29] However, this will be more complicated than the existing system. For example, it will be difficult to ensure that a policyholder who withdraws the return on his pension scheme on an ongoing basis will have the liquidity necessary to pay the tax.

In its Communication of 2001 the Commission recommended that all Member States adopt an EET system. The result would be that Denmark and Sweden would have to abandon their yield tax. Yield tax plays an important role in both Denmark and Sweden in ensuring neutral taxation of household savings. Furthermore, the yield tax generates substantial tax revenue every year. Because of the interaction with yield taxation, the abolition of tax-privileged treatment of contributions paid to foreign pension schemes has a considerably larger impact on Danish and Swedish tax law than on the tax law of the other Nordic countries.

Persons moving to a country

As indicated above, the Commission has argued that special consideration should be given in respect of persons moving to a country. The fact that a person – under the same conditions as with contributions paid to a pension scheme in the state of relocation – may enjoy preferential tax treatment in respect of contributions paid to a pension scheme in the state of origin will, as observed by the Norwegian reporter, often result in the non-fulfilment of the requirements.[30] The reason for this is the lack of harmonisation between individual countries of the requirements for obtaining preferential tax treatment of pension contributions.

Of the Nordic countries, *Finland*, *Iceland* and *Sweden* have rules that make it possible to obtain preferential tax treatment of contributions to a pension scheme contracted in the state of origin; see above. In contrast, *Denmark* and *Norway* do not generally allow preferential tax treatment of contributions paid to a pension scheme in the state of origin.

If a person's pension benefit is paid from the state of origin, the principles of freedom of movement should ensure that the benefits are not taxed if the contributions were not subject to tax privileges. Since 1998 the *Danish* rules have provided that no tax will be levied when benefits from a pension scheme are paid provided no privileged tax treatment was given to contributions – neither in Denmark nor in the state of origin. In contrast, all pension benefits are taxed in *Finland* and *Iceland* no matter whether privilege tax treatment was granted to the contributions paid to the pension scheme. For movements from one Nordic country to another, this is likely to have only insignificant impact, as contributions in all Nordic countries are usually paid to tax-privileged pension schemes.

[29] It is debatable whether this difference between Swedish and foreign pension schemes is contrary to the principles of freedom of movement, see the Swedish national report, Section 6.6.2.3.
[30] See the Norwegian national report, section 6.4.

Tax incentives for people to emigrate or immigrate

Incentives may be provided for moving from one country to another if the double-taxation treaty confers the right to tax on the state of residence (e.g. France or Spain) and the income is taxed at a lower rate in the state of destination. This is one of the reasons why Finland amended its tax laws in 2006 so that both the value of deductibility for contributions paid to a voluntary individual retirement plan and the tax rate applicable to pension benefits paid from such plans was fixed at 28% (as capital income).

In *Norway* pension benefits are not subject to limited tax liability. This is in itself an incentive to move to another country that either levies no tax (e.g. under the provisions of a double-taxation treaty) or levies tax at a rate lower than that applicable in Norway. In the Nordic double-taxation treaty the subject-to-tax-provision entails that the right to tax is transferred from Norway to the state of residence when no tax is levied in Norway. Tax exemption in Norway merely leads to taxation in another Nordic country. The Ministry of Finance is working on a proposal which will make pension payments to non-residents subject to Norwegian withholding tax.

In *Sweden* non-residents are subject to withholding tax at a flat rate of 25%. No deductions are allowed. This may be an advantage in some cases and a disadvantage in others compared to the taxation of residents (and may therefore be contrary to the principles of freedom of movement; see the discussion of the reasons for amending the Finnish rules governing taxation of non-residents above).

7. Implications for capital markets and financial stability

Tax deductibility implies that people have a strong incentive to save for their old age through institutions that fulfill the requirements for obtaining favorable tax treatment. A very considerable part of the explanation why pension funds and insurance companies today play a significant role on the capital market is that individual saving outside the tax-favored arrangements is not competitive. The institutional structure on the capital market, the impressive size of bond and equity portfolios managed by pension institutions and the relative modest role of individual investors must therefore partly be seen as a consequence of the pension taxation systems. The institutions are today major suppliers of funds on the capital market and provide financing opportunities for companies via issue of bonds and shares.

The legislation in the Nordic countries prescribe portfolio diversification for institutional investors. There is a ceiling on the number of shares and bonds issued by an individual company that can be owned by a pension fund or an insurance company. There are also diversification rules for banks. The institutional concentration of shareholdings is somehow modified by the diversification rules but the portfolios are today so large that the role of the institutions in corporate governance has come on the political agenda. So has the ability of the pension institutions to fulfill their future obligations to the pensioners. Some of them have issued interest rate guarantees at a level which is high in comparison with the interest level in the bond markets in recent years.

Exhibit 7.1 gives an overview of the importance of pension fund assets and life insurance investments as a proportion of GDP in the Nordic countries and in OECD as a whole.

Exhibit 7.1. Pension Funds and Life-Insurance Assets in the Nordic countries
As a percent of GDP. End of year 2004.

DK	91.7 %	
FI	60.1 %	(includes mandatory pension plans)
NO	32.6 %	
SW	65.4 %	(includes assets of the Premium Pension System)
IC	146.2 %	
Total OECD	108.7 %	

Source: OECD Global Pension Statistics, OECD Insurance Statistics Yearbook Paris, http://www.oecd.org/dataoecd/29/10/36207938.xls

Pension institutions are important players on the capital market in *Denmark.* One should keep in mind, however, that the capital market is very open. Foreign institutions own a large proportion of bonds and shares issued by Danish companies and institutions, and Danish pension institutions invest to a large extent in foreign securities.

At the end of 2005, Danish pension institutions owned approximately 11% of the total market value of shares listed on the Copenhagen Stock Exchange (OMX), and approximately 28% of the market value of Danish bonds.

Several Danish pension institutions have guaranteed their members or customers a minimum interest rate of 4,5% per annum. Some of the pension promises are unclear and it is possible that some of the institutions will have difficulties in fulfilling their obligations.

The Danish Financial Supervisory Authority (Finanstilsynet) follows the robustness of the pension institutions closely. The supervisors apply a socalled “traffic light system.” An institution is classified as being in the green light if it has sufficient reserves after a combination of a 30% decline in share prices, an unfavorable change in the interest level of 1% and a drop in real estate prices of 12%. An institution is in the yellow light if it can afford combination of a drop in share prices of 12%, an interest level change of 0.7% and a real estate price drop of 8%. Finally, an institution is in the red light if it cannot afford the last combination of adverse events. According to the most recent report from the Danish Financial Supervisor, no Danish pension institution was in the red light in 2005. The Danish State has not issued any guarantee for the obligations of the pension institutions.

The pension funds in *Finland* own in 2006 assets approximately corresponding to 65% of GDP. They are the biggest investors in the Finnish economy. The pension institutions have invested a lot in foreign equity and bond markets.

About 50% of Finnish listed shares are owned by foreign institutional investors. Foreign ownership in Finnish companies is exceptionally high in international comparisons. Favorable tax treatment of pension saving explain the important role of institutions in Finland.

Private life/pension insurance companies and pension funds do not play a dominant role in the stock market in *Norway.* The bulk of pension liabilities are public. At the end of 2005, private pension institutions owned 2.43% of the market value of stocks listed on the Oslo Stock Exchange. The Government and the municipalities owned 34.38%.

The limited role of the private life insurance companies and pension funds is reflected in the relatively low percentage 32.6% of their assets divided by GDP in Exhibit 7.1.

The Financial Supervisory Authority of Norway follows the financial robustness of the pension institutions. Capital reserves of the institutions are according to the most recent report sufficient.

According to statistics presented by the Swedish economic report, the total assets of the insurance companies and other pension institutions in *Sweden* amounted to SEK 1850 billion at the middle of the year 2006. The largest items in the balance sheet of the institutions were respectively Swedish bonds (25.3%), foreign shares (18.0%), Swedish shares (33.0%) and foreign bonds (9.7%). The pension institutions also have considerable real estate holdings in Sweden and abroad.

The dominant role of the public pension system in Sweden explains to some extent why the asset/GDP ratio 65.4% in Exhibit 7.1 is relatively low compared to the OECD average. The assets of the Premium Pension System are included in the asset/GDP ratio but they are still relatively small compared to the Swedish AP-funds.

In *Iceland*, the number of pension funds has been steadily decreasing in recent years. There have been several mergers of funds over the past few years. The ten largest pension funds owned 75% of the net assets of all pension funds at year end 2005.

Partly due to the favorable age composition of the population in Iceland, contributions to pension funds are still far in excess of payments from them. In addition, the funds have earned considerable returns on their investments. The level of pension fund and life insurance company assets in relation to GDP at the end of 2004 is as documented in

Exhibit 7.1 at 146.2% which is much higher than in the other Nordic countries. The growth in pension funding is to a large extent attributable to the Icelandic mandatory pension schemes.

Some of the Icelandic pension funds are under pressure. At the end of 2005, the actuarial position of 16 active non-guaranteed mutual pension funds out of a total of 38 was negative. On the whole, however, the Icelandic pension fund system faces according to the National report only relatively minor problems.

Concluding remarks

The Nordic countries are small open economies with a high level of social security. They are in many respects similar. That applies to their solid democratic foundation, demographic structures and the robustness of their financial markets and Government budgets.

Their pension and tax systems are more or less adapted to recommendations from the World Bank, OECD and EU and to openness of the society in the sense that the implications of international mobility of employees, business firms, pensioners and capital are taken into consideration. They all have legal provisions that are intended to protect their tax base. Cross-border transactions and movements of people and firms within the Nordic area are regulated by the Convention between the Nordic Countries for the Avoidance of Double Taxation.

Pension and tax systems have far-reaching consequences not only for Government revenue and funding of public and pension fund expenditures but also for international competitiveness, employment, economic growth and income distribution. The similarity between the pension and tax systems reflects to some extent that most Nordic politicians share views regarding the objectives of these systems. They want to design legal frameworks that can ensure high employment, economic growth, social security and an equitable income distribution. Opinions do of course diverge especially concerning distribution issues, but the objective of preventing poverty for disabled and/or old people has very broad support in all political parties. The distribution objective covers also ideas concerning intergenerational fairness. The current pension level financed by the public sector should not be so generous that unborn generations must cope with a large Government debt. If people want to have a very high living standard in their old age, they must contribute by voluntary saving during their working life to provide the extra funding.

Together, the National reports and the General Report represent a comprehensive basis for comparative analysis. The reports show that there are many similarities but also some differences among the pension and tax systems in the Nordic countries. The relative importance of the 3 pillars in the pension systems varies from country to country and the balance between them is developing due to pension reforms. Pillar one – tax financed public pensions – is strong in all countries, but there seems to be a tendency to increase the weight of occupational mandatory pension schemes and defined contribution schemes in pillar 2. That applies in particular to Denmark, Norway and Sweden. Tax incentives to private pension saving – i.e. pillar 3 – are within certain limits on deductibility relatively generous in Denmark, but both Sweden and Denmark levy a tax on pension portfolio returns while Finland, Norway and Iceland do not. In Norway, the Government intends to abolish the preferential tax treatment of pension saving schemes other than the OPA and DCA schemes. Freedom of choice of pension institution and pension scheme seems to have political support in some pension systems more than in others.

Differences in pension and tax policy have implications for capital markets. The accumulated privately managed assets of pension funds and life-insurance companies represent a much larger proportion of GDP in Iceland and Denmark than in Norway, while Finland and Sweden is located in the middle. The borderline between public and private provision of pension services is drawn differently in the Nordic Area.

A general report can never do justice to the impressive amount of important institutional features that are mentioned in the National reports. Thus, the authors of the general report want to conclude by thanking the National authors for all their work and by apologizing for all the omissions and possible misunderstandings that we have made above.