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Pension Financial Security in Germany

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Chapter 3
Pension Financial Security in Germany

Peter Ahrend

Importance of Occupational Pensions

The provision of retirement income in Germany is principally based on three sources: social security, company-sponsored pensions, and private retirement accounts. However, 80 percent of the working population draw the main part of their retirement, disability, or survivors' income from social security.

The financing of Germany's social security system is shared equally between the employer and the employee. The actual contribution rate for each is 9.6 percent of income up to the social security contribution ceiling of US$ 4,606 per month, in 1994.[1] Social security is based on a pay-as-you-go system, often referred to as the "contract between the generations," since the working population finances the current pension payments (principle of solidarity). Because society is aging and contribution volumes are becoming insufficient, the social security system will face severe problems in the future. At present, German social security insurance can rely on a relationship of contributors to retirees of 100 to 44. However, by the year 2040 this ratio is expected to have worsened to one to one.

Once reform measures have become completely effective by 2012, the average social security pension will stabilize at a lower level, relative to earnings. The "income gap" opening up between this percentage and the income required to maintain the prior standard of living can only be closed by private retirement accounts and occupational benefits. The actual extent of the income gap depends not only on the social security level but also on the net income of active employees, which is determined by the percentage of gross income payable as taxes and social security contributions. This was 16 percent in 1960, 23 percent in 1970, 29 percent in 1980, and has risen to around 33 percent at present. The resulting de-

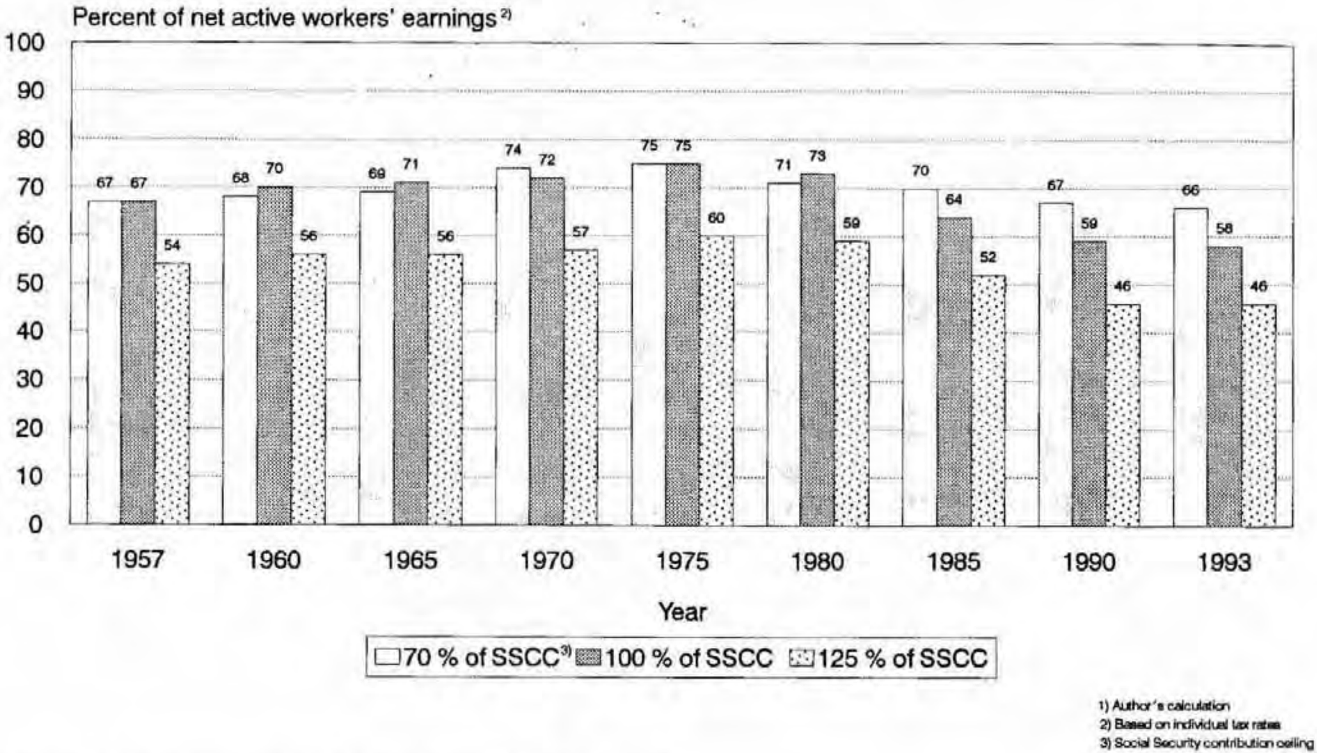


Figure 1. Net replacement level of social security, West Germany.[1]

velopment of the net replacement level of social security over the years is illustrated in Figure 1. The actual income gap for 1994 is shown in Figure 2. In this context it should be pointed out that for a large part of the population the possibility of making private provisions is quite limited since this has to be done from taxed income. In general, individuals cannot establish individual retirement accounts and receive a tax deduction.

Due to the reduction of the social security level in the long term, as well as to the restricted possibilities for private provisions, the subject of occupational pensions has become an important issue of social policy. To provide an overview of the general economic background to any benefit issues, the development of wages, the cost of living, social security, and productivity since 1957 have been depicted in Figure 3.

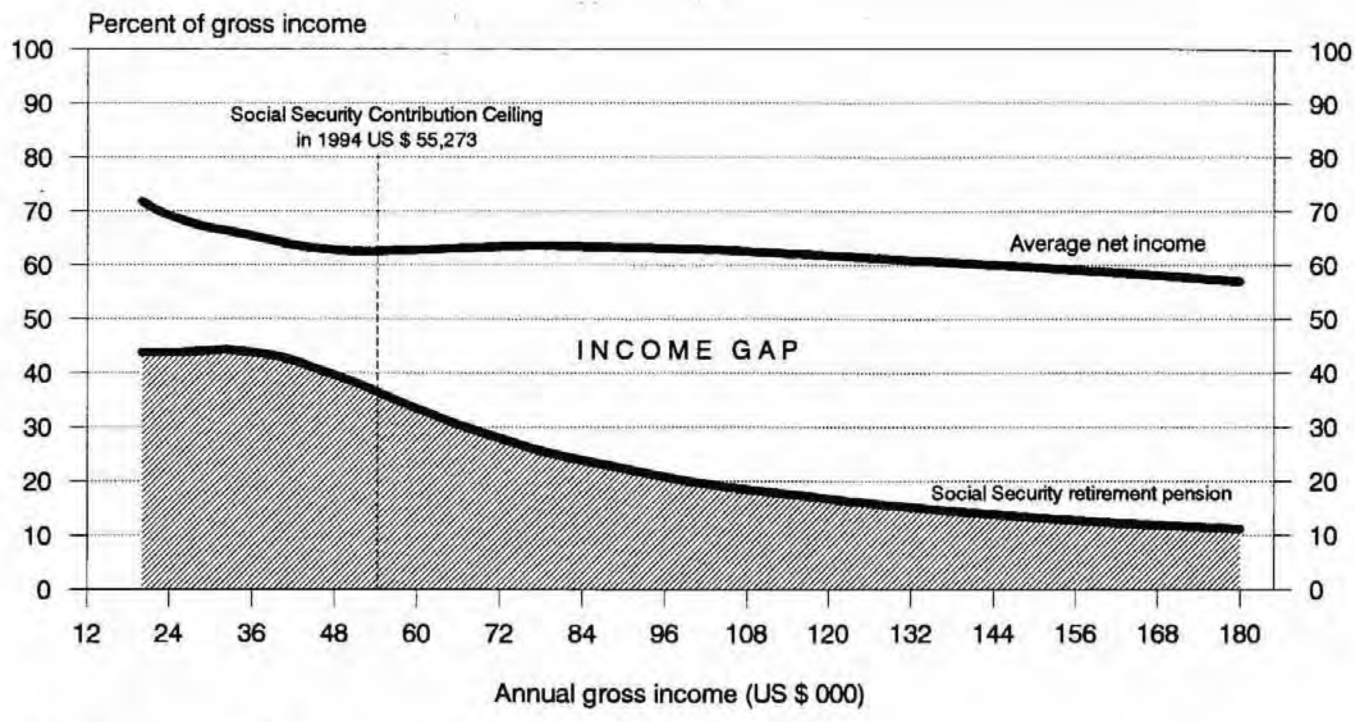
The Historical Development of German Occupational Pensions

The Early Stages

The first German company-sponsored pension plans were established in the middle of the nineteenth century by chemical companies and those in heavy industry. These were characterized by their patriarchal approach and the employee's personal dependence on the employer. Their purpose was to protect old people who could no longer rely on the social network of a large family, since the latter as a "workplace and household entity" disintegrated during the course of industrialization. Employers, therefore, were predominantly driven by "care" motives for their former employees. At the time when statutory disability insurance was introduced for workers (1891) and subsequently extended to salaried employees (1911) company pension plans were already becoming widespread. Their spread was further helped by the inflation of 1923, which completely destroyed any private retirement accounts employees might have made (devalued savings versus provisions out of current company earnings). Along with the change in the employer-workforce relationship that took place between the two world wars the provision of company-sponsored pensions became based more and more on objective reasons rather than on personal motives. The moral concept of responsibility for staff welfare was replaced by the principle that a pension was a fringe benefit provided by employers.

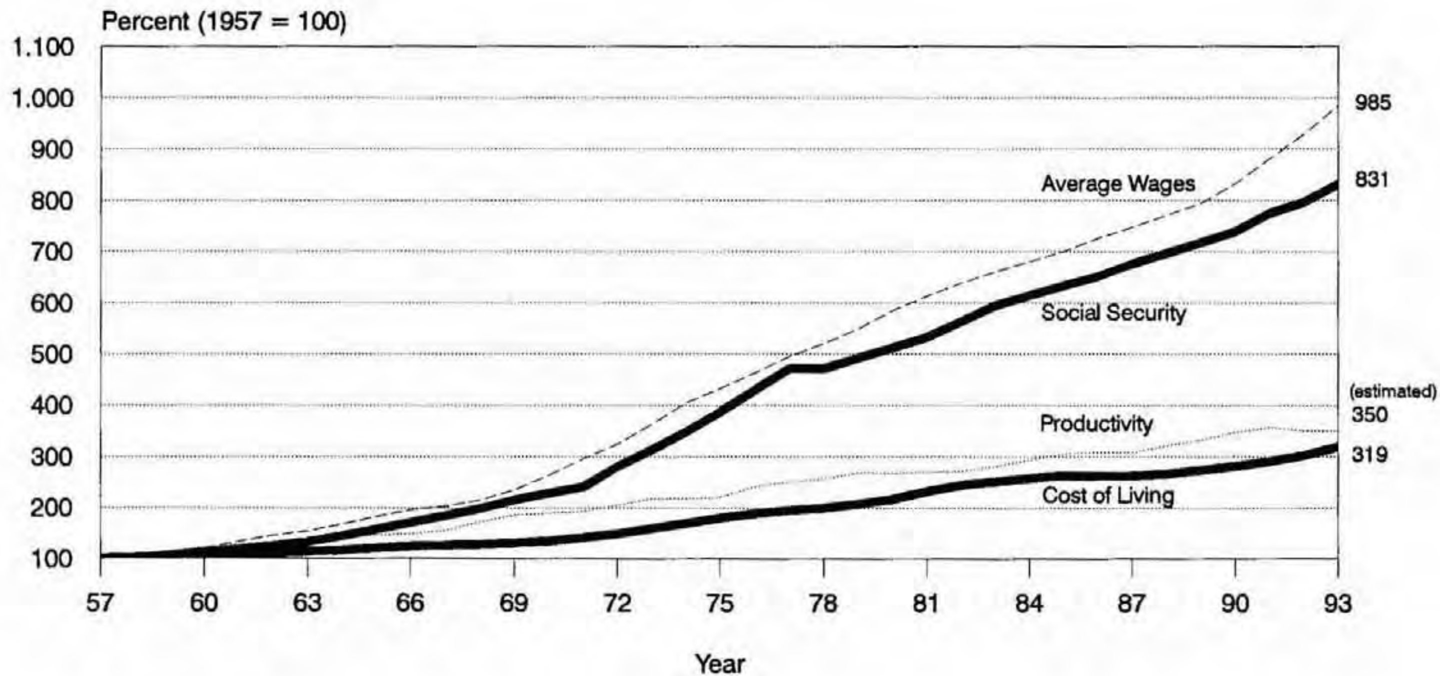
After World War II: Setting the Course for the Dominance of Internal Financing

High inflation in 1948, in the aftermath of the second world war, set the course for today's dominance of internal financing for occupational



1) Author's calculation using 1 US $ = DM 1,65

Figure 2. Illustration of the income gap, West Germany, 1994[1] (percentage of gross income).



1) Author's calculation

Figure 3. Development of average wages, productivity, social security, and cost of living, West Germany.[1]

TABLE 1 Spread of Company-Sponsored Pensions in the Industrial Sector in Germany (Western Laender)

	Companies with an Occupational Pension Plan (% of companies belonging to the respective group)			*Employees Entitled to Company-Sponsored Pensions (% of employees belonging to the respective group)*		
Industry	*1981*[1]	*1987*[2]	*1993*[3]	*1981*[1]	*1987*[2]	*1993*[3]
Number of Employees						
20–49	50	39	45	27	23	18
50–199	75	75	73	47	46	40
200–999	92	91	91	70	68	62
1000+	97	99	97	85	91	85
Industry Total	67	61	64	70	72	66
Basic and producer goods	77	72	71	76	83	78
Capital goods	70	62	66	75	78	69
Consumer goods	59	54	57	53	50	46
Food processing	68	64	65	62	59	57

Sources: [1]Ifo survey June/July 1981; [2]Ifo survey November/December 1987; [3]Ifo survey June/July 1993.

pensions, to be examined shortly in more detail. According to the (currency) Transition Act June 1948 (*Umstellungsgesetz*) all pensions directly paid by companies had to be continued to be paid completely, whereas all other kinds of occupational retirement benefits were converted at a ratio of 10:1 from "Reichsmark" into "Deutschmark." Encouragement of the internal financing method, which until then was scarcely to be found, was due to economic and fiscal considerations.

Like all other economic sectors, the banking and financial sector was devastated, so reconstruction of the economy based on loan capital was impossible. In addition, the tax law of the allied forces (Allied Control Commission Act. No. 12 of February 1946) imposed marginal tax rates of up to 90 percent on company profits. Disclosing a liability for future pension obligations in the balance sheet meant that income taxes could be deferred and the means to finance reconstruction were made available.

For employees the extension of occupational pension systems meant an improvement in their retirement provisions. In 1948 the level of social security was around 25 percent of net earnings and was intended to provide the necessary means of existence. With the Social Security Reform Act of 1957 this objective was altered in favor of the maintenance of the prior standard of living. Today an employee with a salary of US$ 2,425 per month can expect to receive a pension of 47.5 percent after 45 insur-

TABLE 2 Spread of Company-Sponsored Pensions in the Trade Sector in Germany (Western Laender)

Trade	*Companies with an Occupational Pension Plan (% of companies belonging to the respective group)*			*Employees Entitled to Company-Sponsored Pension (% of employees belonging to the respective group)*		
	1981[1]	*1987*[2]	*1993*[3]	*1981*[1]	*1987*[2]	*1993*[3]
Number of Employees						
3–5	21	23	28	12	9	12
6–9	28	38	36	12	19	11
10–19	40	32	42	12	11	12
20–49	50	47	55	15	15	16
50–199	67	71	61	27	28	23
200–499	81	85	70	30	44	27
500+	85	87	85	62	54	61
Trade Total	30	32	34	28	28	28
Wholesale trade	37	31	38	30	29	27
Retail trade	27	33	33	28	27	28

Sources: [1]Ifo survey June/July 1981; [2]Ifo survey November/December 1987; [3]Ifo survey June/July 1993.

ance years. However, it should not be forgotten that in former days all company pension entitlements were lost once the employee decided to move to another employer.

The extent to which company pension plans are now to be found in companies in industry and trade is illustrated in Tables 1 and 2.

Legal Foundations of Occupational Pensions

Only in very exceptional cases are German occupational pension plans mandated to provide company benefits, as is the case in countries like France, Finland, Sweden, and Switzerland. Occupational pensions in Germany are governed by tax law and labor law, as well as insurance control law and trade and company law. However, when company-sponsored benefits are granted by the employer on a voluntary basis, a pension obligation exists only if an actual liability has been established. Under the German legal system even an oral promise is binding, although a written statement is required if book reserves are to be disclosed in the tax balance sheet.

On a collective basis, a pension entitlement can be established either through an agreement with the works council or through a collective agreement. However, the benefit levels of such codetermined pension plans generally do not differ significantly from plans established without employee codetermination. Accordingly, the character of company pension systems is a voluntary and additional one following the principle of subsidiary.

Generally, the legal foundations of a company pension scheme can be of an individual or a collective nature. As regards the possible forms of individual contracts, special attention is required by the so-called "standard contractual regulation" and the "overall pension promise." The former represents a number of identical individual pension promises, whereas the latter describes a pension promise by established individual contract, yet given to the entire workforce or to a certain group of employees, either by publishing the pension plan on the notice board or by an oral or written announcement. Both are individual contractual pension promises to each individual employee, but they still contain a collective element, since all employees or groups of employees receive identical pension promises.

Further legal foundations for the creation of pension entitlements on an individual basis are the principle of equal treatment as well as the interpretation of "standard practice." According to the principle of equal treatment, equal facts have to be treated in the same way if there is no substantial reason for differentiation. With regard to occupational pension benefits this principle means that employees may not be excluded from pension promises if comparable employees are given pension promises.

The principle of "standard practice" applies if no formal written or unwritten pension promises or plans exist, but nevertheless the employer regularly provides benefits according to a certain scheme. This practice establishes a pension entitlement for active employees.

Important Aspects of Labor Law

Once an occupational pension scheme has been introduced by the employer, it is subject not only to the Law on the Constitution of Business Undertakings, the code of civil law, and extensive case law but also to the minimum standards set by the Improvement of Occupational Pensions Act (*Gesetz zur Verbesserung der betrieblichen Altersversorgung* [BetrAVG]) of December 1974, with a volume of 32 sections not including the tax provisions. This act was drafted for employee protection, improving their status in several areas.[2]

Vesting

This provision was intended to facilitate the mobility of employees, desirable in times when the economy is prospering, by recognizing that an employee's pension entitlement depends on the employee's having worked for a company until retirement. Irrespective of who initiated the termination of employment, an employee will keep his or her pension entitlement under section 1 BetrAVG if he or she has attained age 35 and the pension promise has been in existence for 10 years or if the employee has been with the company for at least 12 years and the pension promise has been in existence for at least three years. The amount of the vested entitlement will then be determined on a pro rata temporis basis. First, the entitlement has to be calculated on the basis of what the employee would have had if he or she had stayed with the company until normal retirement age. Then this theoretical entitlement is reduced by the ratio of actual service years to total possible service years.

Restrictions on Offsetting and Reductions

It is not permitted to reduce benefits in course of payment after the occurrence of the pensionable incident by taking into account the indexation of other benefits. Furthermore, it is also forbidden to take into account other benefits that have been financed entirely by the employee. This does not apply to social security benefits as long as they have been financed equally by the employer and the employee or to other benefits that the employer has financed by at least 50 percent.

Early Retirement

Under the BetrAVG the employee can claim the company pension before attaining normal retirement age (usually age 65) if the employee draws a full retirement pension from social security. However, the law does not mention the amount of this early retirement benefit, leaving it to the contracting parties to determine. In practice, an actuarial reduction rate is often applied for each month before the normal retirement date the pension is received. In the majority of cases this reduction rate has been set roughly actuarially neutral at 0.5 percent. Its purpose is to compensate for the longer payment period resulting from the earlier retirement date.

Insolvency Protection

Under the BetrAVG, provisions are made in the event the company should not be able to meet the claims arising from its pension scheme. All pension plans except those through pension funds and direct insurance with irrevocable rights are subject to the mandatory insolvency insurance established by the Act. Because of the fundamental importance of insolvency insurance for this chapter, this subject will be examined in more detail later.

Adjustment of Pensions in the Course of Payment

Regulation was introduced by the BetrAVG to protect pensions against inflation in the course of payment. It does not apply to deferred pension entitlements before payment and lump sum payments. Every three years the employer is obliged to review whether an adjustment is required. Specific factors to be considered include the needs of the beneficiary and the economic situation of the employer. As established by a decision of the Federal Labor Court, the needs of beneficiaries are described as compensation for the inflation rate according to a specific consumer price index. Only if the net incomes of the active employees have been growing slower than the rate of inflation during the past three years may the employer provide a benefit increase at this lower rate. The adjustment may be entirely or partially avoided if the economic situation of the company does not allow a full adjustment. This would be the case if the burden of adjusting all pensions under review would have to be met out of company assets.

Until recently it was generally accepted that at any review date adjustments only had to be made for the three-year period immediately prior and that a decision whether to adjust fully, partially, or not at all would be final without any consequences for later review dates. However, on April 28, 1992 the Federal Labor Court decided that any adjustments avoided since the beginning of pension payment will have to be made up for at a later date, once the economic situation of the company permits. Any former adjustments exceeding the cost of living requirement may be taken into account. Further, the development of the net incomes of the active employees of the company is used as a standard of comparison.

Germany is the only country within the European Community that has imposed an obligation to adjust pensions derived from voluntary occupational retirement benefit plans. In other countries, mandatory indexation of pensions exists but only as regards obligatory company pension systems. So, the difference concerns whether the company pension system is obligatory or not. Whereas in other European countries the adjustment is indirectly obligatory (because the company pension system as such is mandatory), in Germany the adjustment is obligatory but the company pension system is not mandatory.

Types of Financing Arrangements

Occupational pensions in Germany can be financed either directly by the company through accrued book reserves (internal financing) or through a legally independent institution (external financing), in which case actual contributions have to be paid. Consequently a differentiation is made between direct and indirect pension promises.

The employer may choose among four different financing methods: direct pension promise, support fund, direct insurance, and pension fund. The benefits granted usually include retirement, disability, and survivors' benefits and are paid as either a pension or a lump sum, although lump sum benefits are of little importance in Germany. A summary of their characteristics is given in Table 3.

Direct Pension Promise

Direct pension promises are the prevailing financing arrangements in Germany. The employer has a direct liability to pay the benefits to the employee or his or her survivors. Hence, the benefits are paid by the company, directly out of the company assets. In the balance sheet the book reserves represent a long-term unfunded pension liability that reduces the taxable company profit. During the time of accrual the deferred tax liability can be used for investments without borrowing from the financial markets. The company achieves a positive financing effect through the accrual of book reserves. Employee contributions, however, are not permitted.

Support Fund

A support fund is a legally independent institution with separate assets, set up by one or several companies. Its legal form is usually a "registered society" (*eingetragener Verein*, e.V.) or a "limited liability company" (*Gesellschaft mit beschränkter Haftung* [GmbH]). A special characteristic is that the employee or the employee's survivors have no legal entitlement to the benefits, since the fiscal treatment generally does not allow a sufficient accrual of funds during active employment, with the exception of current premiums for a reinsurance. Full financing through allocations by the company is possible after the occurrence of a pensionable incident. If the support fund does not have sufficient assets to cover benefit claims, the employer is liable for pension payments. Employee contributions to the support fund are not permitted. A support fund may provide ad hoc benefits.

Pension Fund

A pension fund is a legally independent institution set up by one or several companies. Its legal form is usually a "mutual insurance association"

TABLE 3 Summary of Financing Methods, Germany

Characteristics	*Direct Pension Promise*	*Support Fund*	*Pension Fund*	*Direct Insurance*
legal characteristics/ carrier of benefit promise	company itself	legally independent entity (e.V. GmbH, seldom: trust foundation)	legally independent entity (VVaG)	insurance company
State insurance control	no	no	yes	yes
formal legal entitlement	required for accrual of book reserves in tax balance sheet; otherwise depending on plan	no	yes	yes
Insolvency protection through PSVaG for legally vested entitlements and current benefits	yes	yes	no	no, if irrevocable right; yes, if revocable right or if pledged, assigned or used as collateral
prefinancing of benefits	yes, through accrual of book reserves	no, only accrual for reserves; funds allocated after pensionable incident	yes	yes

employee contributions	not possible	not possible	possible	possible
investment of assets	liberal, no obligation to invest	liberal, as long as business objective of support fund does not change; loan to sponsoring company possible and customary	only according to regulations of the Insurance Control Act; loan to sponsoring company only possible with approval of supervisory authority	loan of insurer to sponsoring company possible by raising a loan on the insurance policy
reinsurance	possible	possible	no	n/a
contributions taxable as income	allocations to book reserve not taxable as income	allocations by the company not taxable as income	taxation with flat rate through company possible, otherwise expenses for provisions within allowed limits	
taxation of pension payments	taxable as income, however tax-exempt amount of 40% (max. DM 6,000 p.a.) under section 19 (2) EStG		only interest part under section 22 EStG	
taxation of lump sum benefits	taxable as income with tax-exempt amount; possible to divide income by three and multiply the income tax on this amount by three [section 34 (3) EStG]		not taxable if duration of insurance was more than 12 years and contributions were acceptable as additional expenses for tax purposes	not taxable

(*Versicherungsverein auf Gegenseitigkeit*). Therefore, it is subject to state insurance control by the Federal Supervisory Office for Insurance Companies (*Bundesaufsichtsamt für das Versicherungswesen*, VaG). Employees or their survivors must have a legal entitlement to the benefits. The pension fund is financed by employer contributions, with employee contributions being possible and customary. This is the prevalent financing method among large companies and certain industry sectors (group pension funds).

Direct Insurance

In direct insurance, a life insurance is effected by the employer, who is the policy holder on the life of the employee. The employee or his survivors have to be fully or partially entitled to the insurance benefit. It is the insurance company who pays the benefits, and the insurance is financed by employer contributions, with employee contributions being possible.

Of the total funds of US$ 244 billion accumulated for all pension purposes in 1991, the individual financing methods accounted for the following percentages:

Book reserves	58 percent
Pension fund	22 percent
Direct insurance	11 percent
Support fund	9 percent

Total expenses for the provision of company-sponsored benefits in Germany, including all financing methods, amounted to US$ 18.45 billion in 1991. In the same year all benefits paid out totaled US$ 10.75 billion (ABA 1993).

Financing Principles

Financing of Direct Pension Promises

To finance a direct pension promise a book reserve has to be accrued and disclosed in the tax and trade balance sheet according to the following provisions.

The company has an obligation to disclose a liability in the trade balance sheet for pension promises effective after December 31, 1986, according to section 247 of the Commercial Code (*Handelsgesetzbuch*, HGB).

If pension promises were given before January 1, 1987 the company continues to have an option whether to disclose the book reserve fully, partially, or not at all under paragraph 28 of the Introductory Act to the Commercial Code (*Einführungsgesetz zum Handelsgesetzbuch*, EGHGB). Nevertheless, stock companies are obliged under paragraph 28 EGHGB to report in the appendix to the balance sheet any book reserves not disclosed in the balance sheet itself.

Under section 6a of the Income Tax Act (*Einkommensteuergesetz*, EStG) a tax-effective book reserve can be accrued for pension liabilities. However, the wording of section 6a EStG provides that the obligation to disclose a liability in the trade balance sheet is decisive for a disclosure in the tax balance sheet. The amount of the book reserve disclosed in the tax balance sheet may not exceed the book reserve determined under commercial law. Any possible deficits in the tax balance sheet may not generally be made up for at a later date. For pension promises effective before December 31, 1986 the option whether to disclose a liability for tax purposes follows the provisions under commercial law.

The main characteristics of book reserves are that they are borrowed capital and that they represent a liability of which the purpose but not the amount (kind and due date) is known. Valuation for tax purposes takes account of actuarial assumptions, such as mortality tables, invalidity tables, and a discount rate of 6 percent (in 1994). In 1955 the minimum discount rate had been set at 3.5 percent. With the Tax Reform Act of 1960 this minimum discount rate was increased to 5.5 percent. A further increase to 6 percent was brought about by the budget law of 1981 (*Haushaltsstrukturgesetz*, German Federal Law Gazette I, 1981, p. 1523). An increase of the discount rate has the effect that the annual allocations to book reserves are reduced, thus leading to higher taxable company profits. With the enactment of the Act on the Improvement of Occupational Pensions (1974) the minimum discount rate became an obligatory discount rate. The reason was the need for a uniform approach to calculate settlements for vested pension entitlements as well as the contributions to insolvency insurance, which are determined on the basis of the book reserves calculated with the "entry age normal" method.

Under this method, each employee is assumed to have entered the plan when first employed or as soon as becoming eligible (age 30 at the earliest to account for fluctuations). The current service cost is a level annual amount sufficient to provide the required benefit in the actuarial valuation, when invested at the rate of interest required by the German tax authority. A higher discount rate would result in lower settlement payments and in lower contributions to insolvency insurance. As another consequence of the entry age normal method, defined contribution plans, which do not focus on a defined benefit but focus instead on a periodic pension contribution volume for cost control purposes are not very widespread, because a pension increase due to a new contribution is also effective for the past.

The mere accounting procedure of accruing book reserves as a long term liability for pension purposes in the balance sheet reduces the taxable profit of the company and, thereby, its income tax burden. However, since the profit of the company increases once pension payments have started, due to the dissolution of the book reserve on an annual basis, the initial tax reduction only represents a long-term tax deferment. The financing effect of book reserve accrual results from the cash flow improvements and the interest payments saved on loan capital.[3]

Financing of Support Funds

The parent company transfers funds for benefit payments to the support fund under the provisions of section 4d EStG. Current benefits may be financed in full, whereas for future benefit entitlements only an overall allocation to a reserve is allowed. Financing as such is quite liberal. The company has no obligation to allocate funds to the support fund. Should the support fund not have sufficient funds for benefit payments, they can be directly paid by the company.

If the company has not transferred sufficient funds to the support fund, this liability does not have to be disclosed in the balance sheet. However, it is obligatory to show this liability in the appendix to the balance sheet (section 28, EGHGB). Allocations are limited in two ways: by the maximum annual allocation and the maximum permitted assets of the support fund. Both restrictions depend on the kind of benefits provided by the support fund—life annuities, annuities, or both.

Like book reserves, allocations to a support fund have a financial effect for the parent company. The allocations reduce its taxable profit and, thereby, the income or corporate tax burden. In addition, it is possible in Germany for the support fund to provide the parent company with a loan out of its funds. This procedure enables the company to substitute equity by loan capital without having to approach external financial markets.[4]

Financing of Pension Funds

A pension fund is a life insurance company in the form of a mutual insurance company and with a non-profit character. Pension funds are financed through contributions during the active employment of the beneficiary and employee contributions are not only possible but standard practice. Contributions have to be so calculated that the pension fund can accumulate the necessary funds for cover during the active employment period. The prescribed discount rate is 3.5 percent. Further, the contributions have to be so calculated that they cover the promised benefits as well as any administration costs, but they may also not exceed this level. On the other hand, the future pension payment must correspond to the contribution payments (principle of equivalence in insurance). This last point applies equally to the financing of direct insurance.

Taxation of German Occupational Pension Funds

To describe the taxation of the four possible financing methods, one has to distinguish between the employer and the employee as well as between the taxation of contributions and final benefits. Generally, taxation is governed by the "principle of income inflow." Accordingly, all different parts of total lifetime income may only be taxed once.

Depending on the financing method, either the pension-financing period is regarded as the effective date of individual taxable inflow (pension fund and direct insurance) or the period of benefit payment (direct pension promise and support fund). This differentiation is due to the historic development of the financing methods; in other words, it has traditional instead of rational reasons.

Taxation of Direct Pension Promises

As has already been explained above, with regard to the employer company the accrual and disclosure of book reserves in the balance sheet reduces the taxable profit and thereby the income tax burden (income or corporate tax and tax on trading profits). However, due to the profit-increasing effect of the dissolution of book reserves at the time of benefit payment, this reduction of the income tax burden merely represents a long-term tax deferment.

With regard to the employer the pension promise as such and the allocations to the book reserves do not represent taxable income. Once the benefits are being paid they are like wages, subject to income tax with several tax-exempt allowances that can be claimed. These tax-exempt amounts are the reason why the benefits are usually below the tax assessable limit. If the benefit is payable as a lump sum, it is fully subject to income tax at the time of inflow. However, it is possible to distribute the inflow over three years for tax purposes according to the Income Tax Act.

Taxation of Support Funds

For the parent company allocations to a support fund represent tax-deductible business expenses within the limits set by the Income Tax Act. The support funds themselves are exempt from corporation tax as well as from trade and wealth tax if the funds meet several conditions: if the support fund has its own legal status; if beneficiaries have no legal entitlement to benefits; if the fund is a social institution using its funds according to its statutes; if beneficiaries must be able to advise on the administration of the assets; and if there are no employee contributions. If the actual assets of the support fund at the end of the financial year are more than 1.25 times higher than the maximum allowed assets, the excess is subject to corporate, trade, and wealth tax.

With regard to the employee, the pensions from a support fund are subject to income tax once they are actually received, analogous to the benefits from a direct pension promise. The statements regarding lump sum payments apply as well.

Taxation of Pension Funds

The contributions of the parent company to a pension fund are tax-deductible without restrictions as business expenses as long as they are in accordance with the statutes of the pension plan or are required to cover deficits.

The pension funds themselves are tax-exempt if the same conditions mentioned for support funds are fulfilled; nevertheless, it must be noted that the maximum permitted assets are higher than for support funds since the restrictions concerning allocations for active employees do not apply. If the pension fund is overfunded, the surplus is subject to wealth and trade taxes. In other words, the contributions are treated like income of the pension fund. The tax liability can be revoked retroactively by using the excess assets for certain specified purposes, for example, for plan improvements.

For the employees, contributions are taxable, with the possibility of applying a flat tax rate. This system is analogous to the direct insurance approach described in more detail below. Of the benefits paid, only their interest portion is taxable.

Taxation of Direct Insurance Plans

With regard to the employer, the premiums for a direct insurance plan are tax-deductible as business expenses. Premiums are only non-deductible if the insurance was not installed for business reasons because of the contractual relationship between employer and employee. The employer is not required to disclose the insurance claim as an asset in the balance sheet, if the person on whose life the insurance has been taken out or his or her survivors are fully or partially entitled to the insurance benefit at the end of the financial year. Raising a loan on the insurance policy is possible without any adverse tax effects.

For the employees the contributions to direct insurance are regarded as taxable income (because of the benefit entitlement an inflow is assumed). The actual pension payments are only taxable on their interest portion. The amount of the assumed interest portion depends on the age of the beneficiary at the beginning of pension payment and has been determined by law. A possible lump sum benefit remains tax-free as long as the duration of the insurance exceeds 12 years and the contributions have been accepted as additional expenses for tax purposes.

By agreement with the employer, contributions can be taxed with a flat tax rate. However, this is restricted to a ceiling of US$ 1,820 per year per employee. To allow for the benefit requirements of older employees this ceiling can be raised to US$ 2,545 for an individual case, if the average of all contributions for all employees covered by a direct insurance contract or a pension fund does not exceed US$ 1,820. To calculate this average any premiums or contributions of more than US$ 2,545 may not be taken into account. The application of the flat rate tax is permissible only if the insurance benefit is not due before the attainment of age 60.[5]

Control and Insurance of Pension Risks

General Principles

As described above, the majority of pension assets in Germany (around 70 percent) are held within the company. Within limits this also applies for use of support funds as a financing method, which can be regarded as external funding only with some reservations, since the support fund does not give a legal entitlement to the benefits and the sponsoring company is still ultimately liable for any pension payments. This becomes particularly obvious if the support fund chooses to grant the company a loan out of the allocated assets. Under these circumstances the pension assets are again directly connected with the economic development of the parent company. Consequently before 1974 it was possible to lose all or part of the pension entitlement if the company became insolvent.

The Act on the Improvement of Occupational Pensions introduced an insolvency protection of pension entitlements in 1974 for all benefits from direct pension promises, support funds, and direct insurance contracts with a revocable claim (sections 7–15 BetrAVG).

Should the employer have pledged, assigned, or used the insurance policy as collateral, even direct insurances with an irrevocable entitlement are subject to insolvency insurance. In the event the insurance benefit is reduced because the employer did not pay all the premiums required, this part is still not covered by insolvency protection, according to a decision of the Federal Labor Court in 1992. Employees can decide to pay the premiums temporarily themselves or even to continue the policy with their own contributions. In any case, the contributions are regarded as part of the employee's salary in order to define his or her claim for compensation in case of bankruptcy and will be partially reimbursed by the labor bureau.

Benefits from pension funds are not subject to insolvency protection, since the beneficiary is the policy holder. Further, pension funds, which in Germany are always established as mutual insurance companies, are subject to the supervision of the Federal Supervisory Office for Insurance Companies. The fate of the pension entitlements, therefore, does not depend on the sponsoring company.

The Pensions-Sicherungs-Verein as the Carrier of Insolvency Insurance

According to section 14 BetrAVG, insolvency insurance is provided by the Pensions-Sicherungs-Verein (PSVaG), a mutual insurance corporation. It has the powers of an institution of public administration. This means, for example, that the contribution assessments of the PSVaG are acts of administration and that a fine may be imposed on employers who do not meet their legal duties concerning insolvency protection. These measures are intended to provide a high level of security for company pension benefits. The PSVaG does not pay the guaranteed occupational pensions itself; it uses a consortium of 74 life insurance companies (in 1992), which share the annuity business purchased from between 14.5 percent for the largest member of the consortium and 0.1 percent for the smallest. Through this solution the risks can be spread efficiently.

Under section 7 BetrAVG, the obligation of the PSVaG in the case of bankruptcy and in cases equal to bankruptcy are defined. These are the following:

- (a) rejection of petition in bankruptcy because of no assets;
- (b) institution of composition proceedings to avoid bankruptcy proceedings;
- (c) settlement out of court after suspension of payments, only by formal consent of the PSVaG;
- (d) suspension of operations within the purview of the Act on the Improvement of Occupational Pensions, if there was no petition in bankruptcy or if the petition would be rejected because of no assets;

(e) serious economic difficulties similar to bankruptcy, only in cases where a labor court or the PSVaG have agreed that entitlements may be restricted or suspended.

It is of no importance who is to blame for the bankruptcy. Even if the insolvency case is the consequence of criminal actions, the PSVaG is still obliged to provide coverage. Further, the employees have a claim even if their employer did not actually pay the PSVaG contributions legally due. The purpose of this principle is to avoid the situation where the security of employees' pension entitlements depends on whether the employer has been respecting the law. In spite of this principle, employers normally do pay the PSVaG contributions legally due, because fines can be imposed on those not paying punctually.

Benefits protected under insolvency insurance include pensions in course of payment (but the PSVaG does not accept an earlier retirement age than age 60) and pension entitlements that are already legally vested at the time of bankruptcy. As far as pensions in course of payment are concerned, the PSVaG has to cover the benefits from the moment of bankruptcy on. Coverage for vested entitlements is due once the pensionable incident has occurred. The PSVaG covers existing benefit entitlements by paying the single premium necessary to purchase annuity contracts from the consortium of life insurance companies.

Scope of Claims

In case of insolvency the PSVaG pays the beneficiaries a pension equal to the benefit the employer would have had to pay according to the original pension plan. However, the PSVaG will not adjust pensions according to section 16 BetrAVG; instead, it has to apply any indexation clauses that have been contractually fixed in the pension plan.

In the event that claims on the PSVaG represent an abuse under section 7, paragraph 5 BetrAVG, it has no obligation to provide coverage. A case of such abuse would be when improvements in the pension plan made within the year preceding insolvency exceeded improvements granted in the previous year. It should also be noted that the PSVaG is not obliged to pay a monthly pension of more than three times the Social Security Contribution Ceiling (three times US$ 4,606 in 1994).

Financing of the PSVaG

According to section 10 BetrAVG, employers are obliged under public law to provide the necessary means to finance the insolvency insurance on a pay-as-you-go basis. Contributions are related to the size of current

TABLE 4 Development of the Pensions-Sicherungs-Verein (PSVaG), January 1, 1975–December 31, 1992

Financial Year	*Members (through Dec. 31)*	*Final Contribution Rate (%)*	*Amount of Contributions (US$ millions)*	*Insurance Cases (no.)*	*Amount of Claim (US$ millions)*	*Beneficiaries Receiving Pension Payments (no.)*	*Beneficiaries with Vested Entitlements (no.)*
1975	31,045	1.5	67.0	249	45.3	5,060	7,290
1976	31,685	1.9	96.7	267	99.2	8,614	8,795
1977	32,102	1.9	103.6	246	77.7	4,745	5,808
1978	32,778	0.7	43.2	187	47.0	4,765	6,785
1979	32,518	1.1	72.1	154	77.3	5,346	8,116
1980	32,547	1.4	101.8	161	103.5	6,879	6,985
1981	33,895	2.0	163.0	246	167.8	11,780	13,228
1982	33,977	6.9	607.5	363	739.6	39,564	55,498
1983	33,746	3.7	333.8	322	313.3	10,689	14,992
1984	33,968	2.6	259.1	369	237.3	8,036	15,601
1985	34,622	1.4	160.8	366	230.0	7,461	9,746
1986	34,848	1.1	138.0	332	226.4	8,135	13,448
1987	35,725	1.8	289.6	307	355.0	15,891	19,873
1988	35,813	0.9	222.4	200	188.3	4,460	7,606
1989	36,051	0.6	86.3	173	170.0	4,943	7,872
1990	36,712	0.3	46.1	156	201.7	5,774	6,837
1991	37,282	0.9	137.5	155	238.9	6,170	6,561
1992	37,758	0.8	136.9	185	257.0	9,914	11,216
Total			3,064.5	4,438	3,775.3	168,226	226,257

Source: PSVaG (1993, p. 147).

benefits and pension entitlements. A uniform contribution rate applies for all companies, not taking account of any individual risks and thus only insuring the abstract insolvency risk. The companies have to advise the PSVaG about their individual assessment bases for contribution. The contributions rate is then determined as the following fraction:

$$\frac{\text{total capital required}}{\text{total of assessment bases of all companies}}$$

For example, the annual contribution rate was 0.19 percent in 1976 and 0.078 percent in 1992. The highest rate charged so far was 0.69 percent in 1982, as a result of the composition proceedings concerning a major company in the electronics industry.

In 1992, 37,800 employers were contributing members of the PSVaG, which covered 7.2 million pension entitlements, of which 2.9 million were benefits in course of payment and 4.3 million were vested rights. Since 1974 the PSVaG has had to cover obligations for 168,000 pensioners and 226,000 employees with vested entitlements (PSVaG 1993). More detailed figures regarding the development of the PSVaG since 1975 are provided in Table 4.

State Guarantees

Should the PSVaG become unable to keep up its activities or should the Federal Supervisory Office for Insurance Companies withdraw permission for its business activities — both highly unlikely events — the assets of the PSVaG together with all its liabilities would be transferred by statutory order to the Deutsche Ausgleichsbank (Federal Bank for Compensation Payments).

General Principles to Ensure Investment Security in Connection with Direct Insurance

Pension funds, like mutual insurance companies and life insurance companies, are subject to the state supervision of the Federal Supervisory Office for Insurance Companies under the Insurance Control Act. In this context, the fund's business plans have to be approved and the investment of funds is subject to the following principles:

(a) Security of investment takes priority over yield;
(b) Profitability: appropriate returns must be ensured;
(c) Liquidity: the portfolio should be made up in such a way that there is access to any necessary current assets at any time;
(d) Diversity: no investment may dominate the portfolio; and
(e) Securing of cover funds, e.g., by investing the means in real estate.

Every three years the insurance company has to submit for review by the Federal Supervisory Office for Insurance Companies a balance sheet specifically set up according to insurance principles.

Current Issues Regarding the Security and Future of Occupational Pensions in Germany

The Situation of Occupational Pensions at Present

The present position of occupational benefits in Germany is marked by continuing recession in the German economy. High additional wage costs are too much for German companies in the current situation. Since no legal obligation exists to provide company-sponsored pensions and the introduction of a company pension plan is therefore purely voluntary, companies are increasingly inclined to economize in the occupational benefits area. This is manifest, for example, in the growing number of pension plans that are closed to new entrants; that is, new employees engaged after a fixed date no longer receive a pension promise. Furthermore companies are becoming reluctant to introduce new pension plans. According to a survey of the Ifo Institut für Wirtschaftsforschung (Institute for Economic Research) carried out on behalf of the Federal Ministry of Labor in November 1993, the number of employees in the industrial sector with a company pension promise has fallen from 70 percent in 1990 to 66 percent in 1993. This illustrates that the downward trend of occupational pension provision observed since the end of the 1980s, particularly in the industrial sector, is continuing.

This phenomenon does not alarm the pension market. In view of the continuing deep recession and the voluntary nature of occupational pensions, the extent to which a reduction of occupational pensions has been witnessed is surprisingly low. The extent of company-sponsored pensions in the trade sector has only decreased from 29 percent of employees in 1990—the highest level so far—to 28 percent in 1993. In all, occupational pensions have maintained their position as the leading company benefit.

This leading role befits occupational pensions in Germany especially because of their function as a supplement to social security, as illustrated by the fact that the majority of company retirement benefits is provided as pension—as in the social security system—and not as lump sum payment.

As in other European countries, social security in Germany faces problems as increasing life expectancy and falling birth rates lead to an aging society and thus to a reduced contribution volume. The pay-as-you-go system of financing social security is hardly able to cope with these changes, a fact that has already necessitated reductions of benefits and will do so again in the future. Consequently, the importance of occupational pensions as the second source of retirement income in Germany is growing. This is reinforced by the fact that German reunification has created an immense need of the state for capital, a substantial part of which is recovered through high rates of taxes that render private retirement accounts almost impossible.

The government is well aware of this situation and tries to avoid putting pressure on the provision of occupational pensions by state measures. For example, in spring 1993 the government considered increasing the legally fixed discount rate for book reserves from 6 percent to 7 percent. This increase would have reduced the annual allocations to book reserves, leading to higher tax revenues for the state, but since it would also have substantially increased the burden for companies with their company pension plans, the whole initiative was rejected in order to avoid worsening the circumstances under which occupational pensions are provided.

For German employees it is not only the issue of occupational benefit provision as such that becomes more important because of the unfavorable developments in the social security system. What comes more and more into focus is the security of pension assets and their independence from the fate of the company, since the existence of many companies is endangered by the continuing recession.

Insured Pensions Promises

The majority of occupational pensions in Germany are financed internally through book reserve accrual; thus, no assets are accrued externally or available if the company becomes insolvent. In spite of this situation a high degree of security of pension entitlements and pensions in course of payment exists.

The distinctive and sophisticated system of insolvency protection provided by the Pensions-Sicherungs-Verein effectively protects current pensions and vested entitlements against the insolvency of the sponsoring company. This German system has proved to be a success even in several precarious cases. Not even the extensive composition proceedings concerning a major company in the electronics industry in 1982 with claims against the PSVaG of around US$ 576 million nor two other spectacular insolvency cases of major steel companies in 1993 with claims of US$ 242 million each could make the system of insolvency protection totter.

Moreover, the system will be further improved as part of the reform of the entire insolvency law that is currently under discussion in Parliament. Here, this reform will review the wording of the provisions of the BetrAVG concerning insolvency protection and enhance the position of the PSVaG as a creditor of the bankrupt's estate.

Entitlements Not Covered by Insolvency Insurance

Pension entitlements that are not yet legally vested are also protected by a special system developed by the decisions of the labor courts. Contractual pension promises once they are given can only be revoked or reduced by the employer under very restricted circumstances. Basically, such measures are only permitted in the case of serious economic difficulties that bring the company close to bankruptcy. In the case of the (partial) revocation of existing pension promises because of such serious economic difficulties, the employer has to bring in the PSVaG before the act of revocation, so that it can cover current pensions and vested entitlements. In case of pension promises established by an agreement with the works council, the possibilities of reducing the benefits are also very limited. Such changes will be scrutinized as to their adequacy and have to be in reasonable proportion to the reasons that caused them.

The Adjustment of Pensions in the Course of Payment

In Germany the current discussion regarding the security of company-sponsored benefits also focuses on the provisions of section 16 BetrAVG, which are intended to protect pension benefits against inflation. Following the decision of the Federal Labor Court in 1992, which held that any adjustments avoided on grounds of the economic situation of the company will have to be made up for at a later date, companies now face substantial financial burdens resulting from their pension plans. Additional problems are due to the fact that the expenses for adjustments can generally not be allocated to the period actually causing them (i.e., the period of active employment of the beneficiary), and thus be pre-financed, since the decision about an adjustment and its extent is always taken after the employee has left the company. This phenomenon of non-periodic pre-financing is even more relevant in the case of retroactive adjustments, as the company still has the accumulated adjustments before it.

As a result, discussion is underway to reduce the risk resulting from retroactive adjustments, so that the circumstances under which company benefits are provided do not deteriorate. In this context, an amendment to section 16 BetrAVG has been proposed that would stipulate that an adjustment of half the increase of the consumer price index would be sufficient and that any lower adjustments for economic reasons would not have to be made up for at a later date.

Occupational Pensions in the New Federal States

In the new federal states, occupational pension plans for the normal workforce are very rare because of the economic situation of companies. The introduction of a company pension plan is only reasonable once the company starts making profits.

Regional fiscal measures may be needed to facilitate the introduction of occupational pensions in the new federal states after the reconstruction of the economy there. Such a measure could include a reduced statutory discount rate for book reserve accrual that would provide tax advantages for the companies. Nevertheless, these proposals remain in the discussion stage at present.

The Success of Book Reserves

In view of the tax advantages granted to companies with pension plans, it has repeatedly been argued that Germany as a stock exchange location is heavily disadvantaged due to the book reserve system. However, the German system of book reserve financing has proven its worth. On the one hand, it would not be possible to separate capital accumulated for pension purposes from the company since it is mainly invested in internal fixed assets. On the other hand, it is not regarded as a disadvantage at all that due to the lack of separated assets there are no large pension funds that could dominate and influence the capital market and indirectly through this currency policy. Nor is the argument that book reserve financing is nothing more than an indirect subsidy to companies convincing. Here it is easily overlooked that the book reserve system fits smoothly with the German tax system and indeed has been created by it. Thus, according to the German tax system a separation of pension assets from the company would be immediately subject to tax, which is not the case in other countries.

The German system of book reserve financing has proved to be such a success that Germany's European neighbor countries have shown an interest in adopting the system.

European Integration: Tendencies and Outlook

The Progress of European Integration and Possible Effects on Insolvency Insurance

The trend seems to indicate that occupational pension systems will be increasingly influenced by European regulations and measures. However, national systems of insolvency protection always depend on the character and rules of their own national labor and tax laws. The definition of what are appropriate instruments for insolvency protection is particularly influenced by the way benefits are financed. If "internal financing" through book reserves is used, as in Germany, the safety of these funds will depend solely on the economic fate of the company.

In the course of European integration, unnecessary restrictions in the area of occupational pensions will likely be eliminated by the process of liberalization and deregulation. To achieve this goal, the European Commission presented a draft proposal in October 1991, the so-called "Pension Funds Directive," but this has not yet been passed by the European Council of Ministers because of the different approaches of the European member states.

The objective of this directive is to ease cross-border services relating to the investment and administration of pension fund assets. This would enable the institutions covered by the Pension Funds Directive—in Germany, the pension funds and support funds—that a company and its subsidiaries have in different countries of the European Community to pursue the joint investment and administration of all pension fund assets, within an overall investment strategy.

The effects of this draft proposal could possibly have an indirect influence on insolvency insurance policy in Germany. Benefits from direct insurance with an irrevocable entitlement of the employee, which are not pledged or used as collateral by the employer, as well as benefits from pension funds, are to date not subject to insolvency insurance in Germany. In each case the pension claim is independent of the economic fate of the company, and life insurance companies as well as pension funds are bound by the strict investment regulations of the Insurance Control Act. The result is a high degree of safety for pension entitlements. Under the draft Pension Funds Directive, these strict investment regulations would be considerably relaxed and thereafter the systematic supervision of investment decisions would be completely dropped (Article 4 of the draft Pension Fund Directive).

For life insurance companies, the strict requirements of the German Insurance Control Act are significantly relaxed by the 1992 Third Life Insurance Directive, which is headed toward national law. It provides that actuarial assumptions be no longer rigidly fixed. Further, it will abolish the approval procedure for rates and conditions, to be replaced by the principle of "single license," according to which only the single admission of the local (national) insurance supervision authority is necessary for a life insurance company to be able to offer the full range of its approved products throughout the European Community without having to set up an establishment in other member states. This might lead to an expansion of insolvency insurance obligations to irrevocable benefits from direct insurance that are not pledged or used as collateral and from pension funds, since pension entitlements based upon the liberal investment possibilities enjoyed by insurance companies and pension funds may no longer be considered sufficiently secure. In the long term, this could result in an increase in the contribution volume for the PSVaG.

Considerations regarding cross-border membership in occupational pension plans and the free movement of labor could also result in changes to the German insolvency insurance system. The existing vesting provisions are regarded by the Commission as a particular obstacle to the free movement of labor. However, reduced vesting periods would lead to an expansion of insolvency insurance, since in Germany under the provisions of the Act on the Improvement of Occupational Pensions only pensions in course of payment and vested rights are covered in cases of insolvency, leaving a considerable number of pension entitlements, that is, those that have not yet fulfilled the vesting period of 10 years, without the protection of the insolvency insurance carrier.

In all probability the expansion of insolvency insurance would result in an increase in the assessment bases. In this connection an essential feature of German insolvency insurance is the link to the tax law stipulation that book reserves can only be accrued from the age of 30. In the event that this age qualification were to be reduced to the European standard, some increase of premiums for insolvency insurance might take place, since pension entitlements could be acquired to a greater extent and, for reasons of employee protection, would probably have to be covered by the insolvency insurance. But such an increase would probably not be too far-reaching. Hence, no further and negative effects on the occupational pensions market are to be feared.

Equal Treatment: Decisions of the European Court of Justice

In the so-called 1990 Barber Judgment, the European Court of Justice ruled that different retirement ages for men and women in occupational pension systems violate Article 119 of the Treaty of Rome and are therefore inadmissible. Irrespective of when the statutory pension is paid, the employer may not differentiate between men and women as regards retirement age or the amount of the benefit. If the employer differentiates, a man can claim to be treated like a woman. Regarding the retroactive effect of this decision the European Court of Justice has supported the view that legal relationships already concluded will not be affected.

Belgian Advocate General van Gerven rendered his decision on four pension cases (using the Barber Judgment) in early 1993. In all four cases his opinion was that the Barber Judgment should have no retroactive effect. Further, the adjustment of retirement ages could be achieved by reducing the retirement age of the disadvantaged sex to the retirement age of the advantaged sex. However, deviating procedures should be allowed. The Advocate General spoke in favor of unisex rates for insurance purposes, but also not with retroactive effect. However, later in 1993 the European Court of Justice ruled in *Neath v. Hugh Steeper Ltd.* that the use of sex-based actuarial factors in funded defined benefit schemes is not contrary to Article 119 of the Treaty of Rome.

The decision on the *Ten Oever* case was given on October 6, 1993. In its judgment the European Court of Justice gave an affirmative answer to the question of whether occupational survivors' pensions represent remuneration in the sense of Article 119 of the Treaty of Rome and that this finding has no retroactive effect on periods before May 17, 1990.

The *Moroni* case was decided by the European Court of Justice on December 14, 1993. The male plaintiff, who was the beneficiary of a German occupational pension plan, claimed that under Article 119 of the Treaty of Rome he was entitled to a company pension from age 60 on, as female employees in the same situation would be. The European Court of Justice held that the definition of different retirement ages for men and women in additional pension plans remains contrary to Article 119 even if this difference is in accordance with the national social security system. Further, the Court decided that in this case the European Community directive 86/378 of July 24, 1986 "On the principle of equal treatment in occupational social security systems" does not conflict with the direct and immediate assertion of Article 119 of the Treaty of Rome before national courts.

Under Article 8 of this directive the member states must initiate steps to ensure that all provisions of occupational pension plans that violate the principle of equal treatment were amended before January 1, 1993. Thus, the European Court of Justice argued that Article 119 of the Treaty of Rome is directly applicable to any kind of discrimination that can be established according to the criteria of Article 119, and that directive 86/378 cannot restrict the consequences of Article 119.

In addition, the Court repeated its decision that equal treatment regarding occupational benefits can only be claimed for benefits resulting from employment periods after May 17, 1990 (Barber Judgment).

In respect of equal treatment, German vesting periods could probably become an issue again. The requirement of attainment of age 35 together with the 10-year service period could be regarded as indirect discrimination against women, since women quit or interrupt their employment careers much more frequently for family reasons.

Cross-Border Employment

In the meantime the European Commission has approached separately the issue of employee cross-border membership in occupational pension plans, a subject excluded from the draft Pension Fund Directive because acceptance did not seem possible at the time. Therefore in October 1992 the Commission presented a "working paper on cross-border membership of occupational pension plans for migrant workers." At present this working paper focuses only on the group of migrant workers. They are defined as employees who are employed by the same employer or group of employers in another country and who wish to remain in the occupational pension system of their home country.[6] It should be noted that all these considerations only concern a relatively small group of employees within the European Community, since according to the paper the number of migrant workers is not more than 260,000.

Conclusion

The provision of retirement income in Germany is based on three pillars: social security, private retirement accounts, and company-sponsored pensions. The expected worsening of the ratio of active employees to pensioners in the social security area will lead in the long term to a stabilization of benefits on a lower level. Hence, in view of the very limited possibilities for tax-efficient private provisions, the provision of company-sponsored benefits will become an even more important issue of social policy—as it is in a European context. Unlike the practice in other European countries, occupational pensions are provided in Germany on a voluntary basis. They are regarded, therefore, as an additional source of income.

Internal unfunded financing through book reserves is the dominating financing method, mainly for historical reasons, and has proved to be a success despite criticism. Apart from the chosen financing method, labor and tax law issues are of crucial importance. Also of considerable significance is the protection of benefits in the event of insolvency, since internal financing depends on the economic health of the company. The process of European integration also has an influence on national law, for example, regarding equal treatment of men and women, cross-border employment, and insurance control. Financially, the reunification of Germany imported serious economical problems. Because the introduction of a company pension plan is only reasonable once the company makes profits, pension plans for regular workers are very rare.

Notes

[1]Throughout this chapter all Deutschmark sums are converted into U.S. dollar figures at US$ 1.00 = 1.65 DM.

[2]For further information see Ahrend and Jumpertz (1995) and Ahren, Foerster, and Roessler (1993).

[3]There are nevertheless some companies—in particular, subsidiaries of U.S. multinationals—that prefer to hold assets that correspond to the book reserve accrual. These are usually companies that have no need to fund their business other than through equity and earnings; in the case of U.S. multinationals, there can be tax and other financial reasons for having a "funded" pension plan. Traditionally, the asset most commonly used to back pension liabilities has been an insurance contract, which will provide the necessary cash to the company to pay the pension when it falls due. However, portfolios of stocks and bonds may also be used. Such portfolios can be especially attractive for U.S. multinationals,

which are more used to such investments for pension plans. Normally, the asset would not be tied legally to the book reserve or pension promise; thus the company remains free to disinvest the asset at any time. From a United States tax and legal perspective, such a pension plan would not be regarded as truly funded. Under section 404A of the Internal Revenue Code, this can have a negative impact on the U.S. parent of a German subsidiary. A solution to this problem would be to create a legal framework around the asset such that it is protected for the sole purpose of paying employees' pensions. This is done by pledging the assets to a fiduciary, an arrangement that comes as close as possible to the English Law concept of a trust. It should be noted, however, that for German accounting and tax purposes the assets would remain the commercial property of the company. The German tax deduction is obtained exclusively through the book reserve accrual, as before.

[4]A support fund also has the option to obtain the financial means for future benefit payments through the conclusion of reinsurances. If this involves annual premiums (not a single premium) the parent company can fully reimburse the support fund for these premiums under section 4d EStG, even if the premium exceeds the maximum possible annual allocations. In such a case the normal allocations have to be reduced by the ratio of the reinsured benefits to all benefits. A reinsured support fund as a form of "outside funding" combines the possibility of pre-financing benefits completely, without the tax problems arising with direct insurance or pension funds, with the easy "handling" of a support fund since no regulations concerning investment, control of the management, or accounting have to be observed.

[5]Interest received is generally regarded as taxable income. Under section 20 EStG interest from savings accounts is taxable as income from capital. After allowing for expenses, interest of up to US$ 3,635 for single persons and US$ 7,270 for married persons is tax-free each year. Any interest received above these ceilings is fully subject to income tax.

[6]Although the introduction of general regulations for cross-border membership in occupational retirement systems for employees working abroad is regarded as hardly realizable because of the different backgrounds in taxation, the paper concludes that a special regulation should be considered concerning a "mutual recognition for supervision and taxation purposes." This would mean that contributions from the country of employment would be tax-deductible on the same basis applicable for equivalent retirement systems in the country of employment.

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Comments by Lucy apRoberts

My discussion of Peter Ahrend's chapter seeks to raise a few essential points of comparison for the pension systems of Germany, France, and the United States. The first two sections pinpoint the most "foreign" aspects of the German and the French systems from a U.S. point of view, namely book reserve financing in Germany and "complementary retirement plans" in France. The last section comments briefly on the U.S. retirement system from a German or a French perspective.

One obstacle to understanding a foreign social welfare system is the fact that what is politically or culturally acceptable in one country may be considered unacceptable in another. A negative value judgment on an aspect of a foreign system can impede understanding how it functions. German book reserve financing may be considered a case in point. In the United States (or in Britain), only financing through a pension fund is considered acceptable for company pension plans. Book reserve financing is frowned upon and is considered as inappropriate as any type of pay-as-you-go financing. It is, however, widely accepted in Germany, as Ahrend points out.

Another obstacle to comprehension is the fact that foreign systems can be based on concepts that do not exist in one's own country. When one first approaches a foreign system, it is natural to project concepts and categories that apply to one's own system onto the unfamiliar one. American retirement plans covering private sector employees are generally classified into two categories: social security and employer-based (or what the British call "occupational") or, alternatively, public and private. In France, much of the retirement income of private sector employees is provided through what the French call *régimes de retraite complémentaires* or *complementary retirement plans.* These plans are not part of the social security system and yet they are not exactly employer-based, at least not in the sense in which Americans usually employ the term. They do not fit into the U.S. classification system.

German Book Reserves

Peter Ahrend has written an excellent description of company-sponsored pension plans in Germany. Not only does he discuss legal and economic aspects of the system; he also touches on the history that has shaped it. He points out that accrual of book reserves is the most widespread financing method for company plans in Germany, accounting for almost 60 percent of total pension plan reserves.

In this method, the sponsoring company accrues book reserves corresponding to the present value of pension promises as liabilities on its balance sheet. As benefits become due, the company pays them out from its assets and the book reserves are drawn down. The term "funding" is generally used to refer to financing through a fund that is separate from the sponsoring employer's books and that invested largely outside the sponsoring company. By this definition, book reserve financing is not a form of funding. But does this mean that many German company plans operate on a pay-as-you-go basis? It depends on how the term is defined. If by "pay-as-you-go" one means a system where benefits are financed as they come due, without anticipation of future expense, then the German system is somewhat different.

The main difficulty of financing a defined benefit plan that covers a restricted group of employees, such as those of a single company, resides in fluctuations in the ratio of pensions being paid out relative to other labor costs. This problem is particularly acute during the long period of steady increase in pension expense that follows the creation of a plan, a period that spans a number of decades. The rise in pension expense is due to the increase over time in the number of retired employees who have qualified for pensions and to the fact that each new cohort of retirees has generally built up more pension rights than previous ones.[1]

If a new plan is financed on a pay-as-you-go basis, the cost in each period will be equal to the pensions actually paid out, and this expense will rise steadily relative to other costs, notably labor costs, until the plan matures. Companies operating in a competitive environment cannot normally afford to meet such a mounting cost; they need to level out pension costs over time, so that they become more or less constant relative to other expenses. The German book reserve system allows companies to do this: like a U.S. company with a funded plan, a German company makes actuarial forecasts of pension expense and accrues liabilities of a size adequate to finance this future expense. This technique allows the company to smooth out costs over time.

The book reserve system could be interpreted as a form of funding with an extreme asset allocation (Altman 1992; Frijns and Petersen

1988); it is as though the plan held only bonds issued by the sponsoring company. In a funded plan, the adequacy of financing depends on returns obtained on external markets; in the case of a plan financed through book reserves, the adequacy of financing depends on returns obtained by the company on its own capital. As Peter Ahrend does in his chapter, one could refer to book reserve financing and funding as two forms of "pre-financing" of pensions, to distinguish them from pay-as-you-go.

One objection to book reserve financing is that employee pension rights are not protected in the event of bankruptcy. In theory, funding insures against this problem: in the event of bankruptcy, the pension fund is used to pay out what is due to former employees. In a book reserve system, only whatever assets remain to the company can be used to cover pension obligations. The Germans have dealt with this problem through an obligatory national insolvency insurance system. This system is similar in many ways to the U.S. insolvency insurance system, and in fact the two were set up in the same year, 1974.

The fact that both countries have insolvency insurance might give pause to those who object that book reserve financing is riskier than funding: in reality, the security of pension rights in funded plans can be endangered by bankruptcy. The assets of a pension fund can fall short of what is required to cover pensions due, either because the sponsoring company has failed to set aside sufficient reserves or because of poor returns or actual losses on investments. When applied to defined benefit plans, the term "funded" is in fact quite vague. It refers to the existence of a fund, but it does not define the relationship between the value of the fund and plan commitments. It might be interesting to compare benefits paid out to retirees by the two national insolvency insurance systems as compared to total benefits paid out by insured plans in the two countries since 1974. Such a study could be a way of measuring which of the two financing methods has proven the most secure up until now.

In the book reserve system, a pension plan generates resources for the sponsoring company. It may be claimed that this system is too risky for employees, who are putting all their eggs in one basket. However, if a plan contributes to the prosperity of the employer, a prosperity that in turn ensures the future not only of pensions but also of wages and employment, it may not be such a bad basket for them to put their eggs in. Peter Ahrend points out that this pattern often applies in Germany even when financing methods other than book reserves are used: "support funds" may make loans to the sponsoring company; "pension funds" may invest in the company within certain limits; "direct insurance" may be used as collateral on loans to the company. Employees covered by a defined benefit pension plan could be considered to have made a kind of loan. In a book reserve system, they lend to their own employer; in the U.S. (or British) funded system, they lend to capital markets.

The commitments the employer makes to employees in a German plan financed through book reserves and in a U.S. defined benefit plan financed through a pension fund are more similar than appears at first glance. In setting up a defined benefit plan, an employer in either country makes a promise to employees concerning benefits, but not concerning financing. In Germany, the plan is often financed through company assets. In the United States, there must be a pension fund, but the plan is in fact backed up by the assets of the company. Should the pension fund fall short of the needs of the plan, the employer has a commitment to make up the difference.

Why do German and U.S. companies use different financing methods? The answer lies largely in fiscal policy: German companies can write off book reserve accruals for pension plans from their taxes and U.S. companies cannot. However, this answer only begs the question, because then one must ask why the tax systems differ. The explanation lies partly in historical factors. Peter Ahrend explains that the book reserve system became common following the Second World War. Tax rates imposed by the allied forces on company profits were high and companies had great difficulty obtaining capital: the banking sector was devastated, financial markets were inoperative, and firms could not obtain capital abroad. With encouragement from the state through tax exemptions, book reserves proved an efficient method of self-financing for many companies; they were able to raise capital internally without having to resort to issuing stock or borrowing. In 1986, pension reserves represented some 16 percent of total balance sheet liabilities of the 184 largest German corporations (Reynaud 1992). Generally, pension plan reserves constitute a large proportion of the balance sheet liabilities of many German corporations.

Cultural as well as historical factors may help to account for differences between the German and the U.S. system. German corporations seem to have a general dislike for financing through issuing securities. In addition, in the United States, it may be that employees—and unions—have little faith that employers will make good on pension promises. Financing through a fund invested outside the sponsoring company protects employees to some extent from the employer going back on the pension promise. The U.S. system originated at a time when funding was encouraged by tax law, but not obligatory. When unions exerted sufficient influence, as did the United Auto Workers, for example, they sometimes insisted on employers building up adequate reserves. Differences in pension plan financing may also be linked to differences in the industrial relations systems of the two countries. Through works councils and the system of codetermination, German employees generally have more of a say in how companies are run than U.S. employees do. Perhaps the fact that German employees often contribute to company finances through their pension plans gives them — and their employers — some sense that they have a right to a say in company policy.

Finally, it is important to remember that the German social security retirement system is far more generous, especially at higher salary levels, than the U.S. (or the British) system. It is explicitly designed to maintain employees' standard of living during retirement and replacement rates are generally quite high. Hence, for most employees covered by company plans, the company pension is only icing on the cake; the cake is their social security pension.

French Complementary Plans

The French retirement system is similar to Germany's in that nation-wide, pay-as-you-go plans provide most employees with pensions that are quite generous in relation to their salaries. It guarantees most employees with full careers a replacement rate of 70 percent or more of net salary, that is, salary after deduction of payroll taxes (Reynaud 1994). What is intriguing about the French system is that employers and labor unions have set up "complementary plans" that are similar to social security in some respects and yet are private institutions. Company plans are rare and provide very little retirement income. The complementary plans are not part of social security, nor are they employer-based, at least in the U.S. sense.

As in the case of the German book reserve system, some historical background is necessary to understand French complementary retirement plans. The French social security retirement system, which was set up at the end of World War II, levies contributions and pays out benefits that are more or less proportional to earnings under a ceiling that is a little above the average wage.[2] In 1947, the national employers' organization and the labor union confederations signed a collective bargaining agreement creating a national complementary plan: this plan pays out supplementary benefits to private-sector *cadres,* that is, high-level white-collar employees. This plan, called AGIRC (Association Générale des Institutions de Retraites des Cadres), collects contributions from employers and employees on salary above the social security ceiling and pays out benefits that are proportional to that salary bracket.

Many cadres had previously been covered by company or sectorial pension plans that had broken down during the War. The new plan paid out pensions on the basis of past service to retiring cadres as soon as it was created (Friot 1994). This measure was designed to compensate them at least partially for the disappearance of their former plans. It was possible because the financing was basically pay-as-you-go.

Originally, AGIRC covered only employees of companies that were members of the national employers' organization, but in 1950 the state made affiliation obligatory for all cadres through a legal process that is quite common in France under which a collective bargaining agreement may be made mandatory for employers who have not actually signed.

Little by little, complementary plans covering other employees were set up in the 1950s and '60s, some by individual companies and some through industry-wide collective bargaining (Lynes 1985). These plans levy contributions from employers and employees from the first franc of salary and pay out benefits proportional to salary. In 1961, they formed a federation called ARRCO (Association des Régimes de Retraites Complémentaires). By 1972, collective bargaining agreements had made affiliation mandatory for non-cadres in most sectors, and many cadres had also become affiliated. In 1972, legislation required that practically all private-sector non-cadre employees be affiliated to an ARRCO plan. By 1976, affiliation had become obligatory for all cadres, who pay in contributions and receive benefits on the basis of their salaries under the social security ceiling. Over time, the different plans in ARRCO have gradually uniformized their contribution rates and benefits and pooled their resources, so that today the federation functions practically like one large national pension plan covering all employees.

Together, ARRCO and AGIRC pay out around one-third of total private-sector retirees' pensions, the rest coming from social security. To draw a parallel with the U.S. private pension system, the French complementary retirement system is something like two nation-wide multi-employer plans: one for all employees and one restricted to the upper echelons. Like U.S. multi-employer plans, the complementary plans were created through collective bargaining and they are jointly run by labor union and employer representatives.

The complementary plans have some reserves, but their financing is basically pay-as-you-go. Technically, the plans could have built up much larger reserves, but employers and unions decided in favor of pay-as-you-go financing for a number of reasons. Because financing is quite centralized, there was some fear that large reserves would become the object of controversy over how the funds were invested and who was to control them. In addition, unions tended to be wary of funding, feeling that it would lead them to participate too closely in the capitalist system. Both employers and unions wanted to keep contribution rates down. Employers in particular felt it would be better to keep money in companies by keeping contributions down rather than building up reserves.

Pay-as-you-go financing enabled complementary plans to pay out benefits on the basis of past service from their creation. From its inception, AGIRC paid out pensions on the basis of past service to retiring cadres. When companies joined ARRCO, newly retiring employees received benefits on the basis of their whole careers with the company, even before their affiliation. This policy offered a certain advantage for financing: it did not take the plans very long to mature, and contribution rates, while high at first, have stayed relatively level; expenses rose over a shorter period of time than would have been the case if the system had not paid out benefits for past service.

There are probably a number of cultural attitudes that can help to explain the French complementary plan system. France generally has a highly centralized political system and its welfare system — even its private component — has become centralized as well. The French also have — or have had — a certain mistrust of financial markets, especially following the period between the two world wars, when inflation wiped out financial assets. It may also be that French employees are loathe to trust their employers to make good on pension promises, so that a national system is perhaps better suited to their expectations. Finally, employers in many industries may have wanted to avoid competition on the basis of labor costs; a national system helps to make them uniform.

The French complementary plans are private institutions, but they are national in scope. In fact, they have come to resemble a sort of second tier of the social security system. The security of their benefits depends on much the same factors as social security pensions. What is extraordinary is the way in which they were set up. Many employers, as well as labor unions, pushed for their creation and expansion. In most other countries, employers have opposed expansion of national retirement coverage and have fought to maintain their own, company-based pension plans.

In recent years, there has been much discussion about encouraging the creation of voluntary company pension plans in France. Some such plans do exist, but tax exemptions are not very generous. There is debate over whether financing should be only through funding or if tax exempt book reserves should also be authorized, as in Germany. Some current legislative proposals offer both options.

The United States as Compared to France and Germany

Compared to the U.S. retirement system, the French and German retirement systems are quite similar in that, in both countries, the vast bulk of old age pensions come from national, pay-as-you-go systems. Company plans are rare in France. They are more widespread in Germany, but provide only about 10 percent of private sector employees' retirement pensions (Reynaud 1992). In the United States, social security pensions are much smaller and employer-based plans pay out much more on average to retired employees who qualify to receive them.

The other characteristic that distinguishes the United States is the way in which social security pensions are calculated: the U.S. system is explicitly skewed in favor of low wage earners. In other words, it is somewhere between an earnings-related and a flat rate system. The German and French systems are not particularly redistributive on the basis of salary level: contributions and benefits are to a large extent proportional to salary; the two systems are basically earnings-related. They both evolved from less generous, more flat rate systems. The 1945 French system only paid out pensions equivalent to part of income under a ceiling; gradually, employers and unions fashioned a second tier of complementary plans that makes the present-day system comes close to providing a uniform total replacement rate (except for the very highly paid). Peter Ahrend refers in his paper to a major change in the German system in the 1950s. Previously, the social security system was designed to provide subsistence income for retired workers. When reform legislation was passed in 1957, the system's objective became to maintain beneficiaries' standard of living in retirement.

Americans often tend to assume that social security systems elsewhere are like their own, that is, that they pay out relatively small pensions, especially to highly paid wage earners. Germany and France, like many other countries in continental Europe, have a different tradition. Their retirement systems provide universal coverage that allows most retirees to come close to maintaining the standard of living they enjoyed during their careers.

Notes

[1]If a plan grants full retroactive rights at the outset, that is, rights for service completed before the plan was set up, the pensions of the first cohorts of retirees will be as large as those of later ones in proportion to their salaries. In this case, the period of maturation of the plan, that is, the time it takes for pension expense to level off (assuming stable salaries and a stable population of covered workers), will be shorter.

[2]In October 1993, the social security ceiling was 12,610 F per month, while the average monthly gross wage (before deduction of payroll taxes) in the private sector was 11,079 F.

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Comments by Marc M. Twinney

Most national private pension systems appear to be similar from country to country. The points in the German system that are different from the United States system are more numerous and important than with other countries. This makes it intriguing to study and compare the German system with the U.S. system.

Once a system is established, it is difficult to imagine whether any other choices might have been possible. When a pension system first comes into being, many choices may be open. Early choices are especially crucial, because they determine the basic structure. Whether a pension system will continue to change depends on the degree to which this structure reconciles what makes all the parties feel secure with what they consider equitable.

In the United States, a primary thrust for future change in defined benefit plans seems to revolve around the degree that underfunded plans can be accepted in the system of guarantees. The more common the features of the pension world become, the more likely that underfunded pensions will be unacceptable inside or outside the United States. This thrust could drive change in German pensions as well.

A second thrust for change worldwide will be to achieve cost effectiveness in the system. Low cost is a primary characteristic of quality in a system that, after all, only stores capital to be used at a later age. Low cost can be used to add more coverage, improve benefits, or reinvest in the economy to support other worthwhile goals that do not require funding, or permit funding that qualifies for tax deduction under U.S. rules. More about such rules later.

My discussion will focus on the few points of similarity between the United States system and the German system in order to understand better the points of difference. These points of difference are the ones most likely to be subject to change in the future, as the European community and North America become more closely integrated economically.

The Importance of Funding

Firms in the United States would prefer to fund their pension plan obligations externally for many reasons. These reasons have strengthened in recent years.

The traditional reason offered to explain why external funding is desirable is that it provides security that pension funds will be available to pay the benefits long term. This is, of course, the most important reason for participants, their representatives, the benefit guarantee system, and the public at large.

Other reasons for the firm to fund externally are to relieve future management of the burden of heavy cash outflows at some future time, to reduce the size of unfunded liabilities disclosed under U.S. accounting standards, and to improve the after-tax profit effect of accrued accounting for pensions. It is worth mentioning that the desire to reduce unfunded liabilities is not solely to make corporate financial statements look better, but also to achieve better credit ratings and lower the firm's cost of borrowing. Similarly, once the return on a diversified pension portfolio approaches or surpasses the firm's cost of capital, the profit effect turns positive. Note that funding the pension plan is a money-losing proposition at the margin if the investments are restricted to fixed income securities, because their performance is inferior both to equity returns and to the cost of capital long term. In some firms, the expected returns on investments in new product are cited as the breakeven for funding. Unfortunately, these returns are difficult to project. Further, the hurdle rates are often set at a high level to allow for variation in projections and to avoid projects whose returns could bring the firm's total return to a level below the cost of capital. As such, these rates are arbitrary and not the correct point to judge returns for pension funding.

Given the reasons for U.S. firms to fund externally, it is not surprising that their German subsidiaries are overrepresented among the funded alternatives and underrepresented in the unfunded book reserve alternatives. This means that German-based firms and, probably, non-U.S. multinationals, will tend to be overrepresented in the unfunded book reserve category.

In the September 2, 1993 *Wall Street Journal* article "Hopeful Assumptions Let Firms Minimize Pension Contributions" by Susan Pulliam, U.S. and non-U.S. underfunded pension obligations were added together for major U.S. multinationals. This was the first time this had occurred in the business press. Initial reaction of the listed firms was defensive, explaining that the results included overseas plans that were not required to be funded, but the article started new thinking inside and outside companies about the potential of funding the obligations worldwide.

German Practice

Many German firms have used an internal fund in the firm to support the book reserve or to diversify the investments of the direct insurance / pension fund arrangements. These "Spezialfonds" were begun in 1968. They have many points in common with the investment forms of a United States mutual fund and even some in common with United States pension trusts and ERISA. Some of the German investment law requirements include the following. (1) Only securities listed on stock exchanges may be used; this excludes notes and any unlisted securities and real estate. (2) Cash cannot exceed 50 percent of the assets. (3) All securities and cash must be held by a depository bank. (4) No more than 5 percent of the assets may be invested in a single issue. (5) No more than 5 percent of a single issue may be purchased. (6) Fund assets must be segregated from those of the management company and not be liable for any claims against the latter. (7) Shares in the fund must be redeemable at any time at net asset value. (8) The funds are regulated by the Federal Banking Authority.

The special funds also enjoy certain limited tax advantages. Transactions are not subject to sales tax, dividends and interest may be received free of withholding tax, the deferral of taxation applies to income from foreign as well as domestic sources, and capital gains are not taxed. These tax advantages do not equal that of the U.S. qualified plan nor of the invested insurance reserves, but they do apply to a higher-yielding, diversified portfolio of equities.

For German firms, these internal funds combined with the book reserve tax deduction begin to approach the cost effectiveness of the United States system. The German system is more complex because the tax deduction depends upon the tax calculation, "Teilwert," not on the amount of funds set aside. Because the firm is the beneficial owner of the special fund, it would be accessible to the firm's creditors.

For U.S. firms, the special funds in Germany fall short of what is needed for a funded plan. They are not treated as a funded plan under United States taxation in the consolidated return, and equally disadvantageous, they are not considered as a plan asset under U.S. accounting standards.

In an effort to counter these shortcomings, a new development sponsored by United States multinationals has been to add security provisions based on the U.S. pension law to the special funds in Germany. These contractual provisions emulate the requirements of ERISA and U.S. pension trusts. This development could become very important to United States firms if it solves the twin taxation and accounting problems that are specific to U.S.-based firms, but not to German-based firms. The reporting effect is taking on greater importance, as mentioned above, in the news media and credit ratings.

One of the issues in taxation is whether the provisions can be made tight enough to perfect the arrangement under U.S. requirements for exclusive benefit without setting off the taxation of the individual participants under local law in Germany as the funds are contributed.

There are a number of differences between the book reserve calculations for tax deductions and the U.S. calculations performed for U.S. accounting and tax purposes. There are also differences between the tax calculations allowed in the United States return for non-U.S. reserve plans. These issues include whether all benefits or only vested benefit accruals are included, the interest rate assumption, the projection of final average salary, the provision for subsidized early retirement, the extent to which mandated post-retirement benefit increases are projected, amortization periods for benefit amendments, changes in measurement methods and assumptions, and experience gains and losses.

Some of these differences mean that the German tax deduction method falls short of the need for a United States valuation for U.S. deductions or for the U.S. accounting standards.

Difficulties of Funding in Germany

A recent tax development in the United States is developing into a substantial problem for U.S. firms operating outside the United States. The problem came to a head in 1993 when the Internal Revenue Service proposed a regulation that combined the ERISA requirements and regulations with the 1986 and 1987 tax changes for pensions with a section of the code that applies to non-U.S. plan deductions and fund income exemptions. This section of the code (404a) was created to apply U.S. rules to deductions of contributions to funded plans and the deduction of book reserve accruals in unfunded plans such as in Germany.

In respect to a qualified funded plan, a U.S. company may reduce earnings by the amount of pension contributions to a trust or an equivalent of a trust, provided the level of local contribution is determined by actuarial valuation using reasonable methodology and provided that United States limitations on deductions, including the full funding limit, are not exceeded. This makes the United States tax limitations extraterritorial, for if the deductions are last in the local or the U.S. return, the contributions are effectively taxed.

The proposal limits the deduction in the United States return, not the amount that can be contributed locally. Thus U.S. practice for tax-deductible funding (not accounting) would prevail. This means that the benefits recognized, assumptions, methods, and amortization all must comply with United States tax law. Apparently the limitations on dollar benefits and contributions on the dollar amount of compensation are believed not to apply. But, the full funding limits and the 25 percent of payroll limitation must be reckoned with. This poses a problem for years in which major changes were made in German plans, such as in coverage, vesting, or benefit increases, and were funded or accrued in one to five years locally.

The 1993 regulation proposes to apply United States tax rules to the exemption of pension fund income as well as to deductions for contributions. The regulation would make the foreign pension fund a passive investment unless the plan is treated as a "qualified" funded plan. This is a much more serious problem than the mere lowering of deductions for funding in the U.S. tax calculations. It attacks the very concept of overseas pension funds for a U.S. firm.

The proposal would make the pension fund non-qualified under certain circumstances, subjecting the income of the fund to U.S. taxation. Failure to meet all the requirements imposed means that the investment income, including past accumulations, would become taxable in the United States.

To meet the requirement in the code, the local "trust" arrangement must comply with all the rules on prohibited transactions, including restrictions on real estate, loans, and investments in the firm sponsoring the plan. The reversion of assets, even if surplus from a non-terminated plan, would fail these tests. It is the legal ability to make an unsecured loan or to take a surplus reversion that creates these disqualifying conditions even if a plan is never in surplus or never takes a loan.

One way to avoid this U.S. taxation is to reduce funding overseas. This is impractical for many firms. Another way would be to attempt to revise the foreign pension fund to meet U.S. requirements. This may be possible to do in many common law countries where trusts exists, but is nigh impossible in civil law countries. It is especially difficult in Germany with the funded pension arrangements as they are described here today.

The effect of the 1993 proposal is to cast a pall over the local funding of pension plans of non-U.S. subsidiaries by U.S. parent firms. This is contrary to an economic policy that would allow or even encourage foreign subsidiaries of U.S. firms to be as competitive an employer as other local and foreign national employers in providing benefits and their financial security. It also restricts firms in non-U.S. markets and the hiring of significant numbers of people at the local site.

The U.S. tax authorities see little justification, given the code, to avoid the effect of their position related to funded plans. The U.S. regulators rationalize this outcome as preserving competitiveness between doing business in the United States and doing business outside the United States, even though that is probably not their effect, given local law and practice.

Pension Fund Investments

Long-term rates of return are key to being efficient in operating a pension fund. In the United States the historical long-term rates, nominal and real, on the three major investment classes are quite familiar. The dominant long-term asset class is common stocks or equities, with fixed income securities and money market instruments clearly behind. The differential in real yield can be as much as three to five percentage points.

Whether this differential is as pervasive in foreign markets or will be as available in the future is unclear. The exchanges and investment bankers in London and Frankfurt provide evidence and arguments that the advantage in favor of common stocks is not much different than in the United States. The size of the Frankfurt market is substantial, reaching 442 billion in U.S. dollars at year-end 1993. The developments reported by Dr. Ahrend concerning the insurance industry's deregulating the investments behind annuities, and the development of the security arrangement with special funds, could hold out the prospect of progress and future efficiency for pension funding in Germany.

Concluding Questions

We have discussed the German conditions and practice of German firms and contrasted them with the German conditions and practice of U.S. multinationals. It would be interesting to examine U.S. practice and conditions for the German multinational. Because a few of the German-owned U.S. subsidiaries have substantial underfunded United States plans, one cannot help but wonder if the book reserve view of funding is not affecting German funding decisions outside Germany.

Finally, one cannot resist asking the larger question about the future of the guarantee system in Germany. The cost trend of the guarantee system is favorable. Over 50 percent of the private benefit values (in 1991), however, appear to be in book reserves, based on the statistics in Ahrend's paper. In the United States, the frequently quoted US$ 53 billion of underfunding (in 1993) is 5 percent of the private pension obligations and assets. In the United States there is a clamor to mandate a solution for this 5 percent problem. One wonders whether similar questions are being raised in Germany about the future of the guarantee system and the book reserve system at their level of funding.