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TABLE OF CONTENTS

EXECUTIVE SUMMARY

Europe is faced with an unprecedented economic and social challenge due to demographic change. The simultaneous phenomena of a drastic rise in the number of old people over the next decades and the shrinking young population will be of such a magnitude that comprehensive and deep-rooted reforms are needed.

The competitiveness of European companies, growth and employment in Europe are in danger if firms and workers have to cope with increasing labour costs due to a rising pension bill. In all Member States, pension reforms are underway. While the measures introduced differ from country to country, all reforms seek both to limit transfers necessary in the future and to increase the finances available. However the way in which these two parameters have been modified is still insufficient in many Member States.

■ NATIONAL LEVEL

There is no single European model of pension system. A "one size fits all" solution is neither desirable, nor appropriate or feasible across the EU. It is only within the Member States that the appropriate mix of measures can be achieved and the necessary consensus around economically efficient and socially acceptable new solutions can be built. Reforms in the Member States should involve a variety of measures including:

➢ Further reforms of the public pension systems

There is a clear need to increase the effective retirement age. Existing possibilities of retiring before the age of 65 with a full pension and the situations where pre-retirement is still possible below 60 should be addressed. Further reforms of the indexation mechanisms of pensions and pre-funding of future liabilities can also be part of the solution.

➢ Development of the occupational pension schemes

This can be mainly done through:

- attractive fiscal incentives,
- removal of double taxation for migrant workers,
- removal of unnecessary restrictions on investment decisions and application of the prudent person principle,
- adequate transferability of pension rights,
- streamlining policy.

➢ Creating room for personal pension schemes

It is important to keep contributions to first and second pillars at an affordable level, in order to make room for individual contributions to personal pension schemes.

EXECUTIVE SUMMARY (CONTINUED)

■ EUROPEAN LEVEL

The primary responsibility of Member States does not mean there is no EU dimension to pension reforms policy.

➢ Exchanging of experiences

The exchange of experiences on solutions is extremely valuable at the EU level.

➢ Enhancing cross-border mobility

Ensuring free movement of people and labour requires the removal of obstacles to pension rights transferability and, in particular, of tax obstacles and of barriers to cross-border provision of supplementary pensions across the EU.

➢ Monitoring national pension reforms

Delaying reforms can lead to a lack of credibility in one country's budgetary policy, which can reduce the credibility for the euro zone as a whole. Stability in the euro-zone justifies monitoring national reforms at EU level.

This monitoring must fully respect the specificity of this policy area. The objectives defined for the purposes of monitoring pension reforms at EU level should aim at the very long-term. Moreover, given the diversity of pension systems, their content cannot go beyond very general orientations with little direct operational relevance. Finally, monitoring of national reform measures should not exclusively focus on the reform of first pillar but should also assess the development of second and third pillar schemes.

Introduction

Europe is faced with an unprecedented economic and social challenge due to demographic change. The simultaneous phenomena of a drastic rise in the number of old people over the next decades and the shrinking young population will be of such a magnitude that comprehensive and deep-rooted reforms are needed.

Such reforms should consist in a variety of measures combined in an appropriate mix leading to new economically efficient and socially acceptable solutions.

The sustainability of pension systems cannot be ensured by targeting a single policy field, but depends on actions in a wide range of inter-dependent policy areas. Pension systems reforms should be embedded in broader sound policies for economic growth and employment. The full implementation of the Lisbon strategy at national and EU level is therefore crucial.

While recognising the complexity of the multifaceted strategy needed to ensure pensions sustainability, the UNICE paper concentrates on pension systems reforms.

Chapter 1 seeks to give an image of the magnitude of the challenge that population ageing represents for the pension systems in EU countries over the next decades. Chapter 2 presents UNICE's assessment of the national pension reforms already implemented or underway. Chapter 3 urges policy-makers at national and EU levels to take further actions to ensure the future sustainability of pension systems.

CHAPTER 1: THE CHALLENGE

1.1. DEMOGRAPHIC DEPENDENCY RATIO ON EU AVERAGE WILL ALMOST DOUBLE OVER THE NEXT DECADES

The population can age either because of a fall in the birth rate, which reduces the number of young people and narrows the base of the age pyramid, or because people live longer, which causes the top of the age pyramid to become wider.

Both of these processes are currently affecting the population of the EU. But besides the previous constant trends of progressive lengthening in life expectancy and low fertility rates, over the next decades a main driving force of the unprecedented demographic pressure comes from the fact that by 2020 the large post-war baby-boom generation will draw on pension systems while the labour force contributing to these systems will be constituted by the relatively small baby-bust generations born after 1975.

A useful summary indicator of these demographic changes is the **old-age dependency ratio** (the share of people aged 65 and over in the population aged from 20 to 64). According to Eurostat projections, for the EU on average this share will drastically increase between 2000 and 2030, going from slightly under 27% in 2000 to almost 44% in 2030. That means that by 2030 there will be only just over two potential workers for every retired person in the EU compared with almost four today.

Table 1: Projections of old age dependency ratio in EU Member States (ratio of people over 64 to working age population, in %)

	2000	***2010***	***2020***	***2030***
Belgium	28.1	29.4	35.6	45.8
Denmark	24.1	27.2	33.7	39.2
Germany	26.0	32.9	36.3	46.7
Greece	28.3	31.6	35.8	41.7
Spain	27.1	28.9	33.1	41.7
France	27.2	28.1	35.9	44.0
Ireland	19.4	19.1	24.5	30.3
Italy	28.8	33.8	39.7	49.2
Luxembourg	23.4	26.2	31.0	39.8
Netherlands	21.9	24.6	32.6	41.5
Austria	25.1	28.8	32.4	43.6
Portugal	25.1	26.7	30.3	35.0
Finland	24.5	27.5	38.9	46.9
Sweden	29.6	31.4	37.6	42.7
United Kingdom	26.4	26.9	32.0	40.2
EU-15	**26.7**	**29.8**	**35.1**	**43.8**

Source: Eurostat

The rise in the number of older people will be such that the increase in the demographic old-age dependency ratio can be halted neither by a sudden increase in fertility nor by any realistic level of immigration.

1.2. THE ECONOMIC DEPENDENCY RATIO SHOWS AN EVEN HEAVIER BURDEN ON EMPLOYED POPULATION

In order to better assess the future economic burden on the population in employment, it is of greater importance to calculate the **economic dependency ratio** (the ratio between the population 20 and over not employed and total persons employed). Currently, this ratio is 0.86 in the EU, which means that approximately one employed person only supports one non-employed person. Within the group of non-working adults nearly 6 out of 10 are below the age of 65. In the EU, one out of two persons in the age group 55-59 years old and four out of five aged 60-64 are not in employment.

A sharp increase in contributions or a sharp decrease in benefits can thus be partly avoided if the employment rate rises. However, raising the overall employment rate will not be sufficient to address the impact of the ageing population. The simultaneous phenomena of a drastic rise in the number of old people over the next decades and the shrinking young age population will be of such a magnitude that more comprehensive and deep-rooted pension reforms are needed to offset this impact.

1.3. EARLY EXIT FROM THE LABOUR MARKET AMPLIFIES PROBLEMS

Since the mid-70s, early retirement for older workers has in most Member States been regarded as a socially acceptable alternative to unemployment and a means to make room for youth employment. As a result of this, the participation rates among older workers are low (see table 2) and the average age of labour market exit is below the statutory pension age in most cases (see table 3).

Table 2: Employment rates by age group in 1999

	B	DK	D	EL	E	F	IRL	I	L	NL	A	P	SF	S	UK	EU15
50-54	60.3	80.4	73.4	60.1	57.2	74.1	62.1	57.2	64.6	70.2	72.7	71.4	78.9	84.2	75.9	69.2
55-59	36.9	70.9	55.1	47.4	44.8	46.8	50.5	36.6	38.2	49.6	41	59.1	54.6	77.8	62.1	50.7
60-64	12.9	34	19.6	30.4	24.7	10.1	35.9	17.9	12.9	18.6	11.7	43.6	22.2	47.9	35.6	22.3
65-69	3.8	6.2	5	11.5	3.9	2.1	14.3	6.2	n.a.	5.2	4.9	24.8	4.4	10.7	11.6	6.5

Source: Eurostat Labour Force Survey

Table 3 below shows estimates for the average age of labour market exit in 1995. The average age of exit from the labour market ranges for men from around 58 (in Belgium and Luxembourg) or 59 (in Austria, Finland, France and the Netherlands) to 63.4 in Ireland or 63.6 in Portugal. For women, it is as low as 54.1 in Belgium or 55.3 in the Netherlands and Luxembourg and goes only up to 62.1 in Sweden.

Table 3: Estimates of the average age of exit from labour market among older workers (1995)

	Males	*Females*
Austria	58.6	56.5
Belgium	57.6	54.1
Denmark	62.7	59.4
Finland	59.0	58.9
France	59.2	58.3
Germany	60.5	58.4
Greece	62.3	60.3
Ireland	63.4	60.1
Italy	60.6	57.2
Luxembourg	58.4	55.4
Netherlands	58.8	55.3
Portugal	63.6	60.8
Spain	61.4	58.9
Sweden	63.3	62.1
United Kingdom	62.7	59.7

Source: "The Retirement Decision in OECD Countries", Ageing working paper 1.4, OECD 1998

Since life expectancy is growing, a fixed (or falling) age of exit from the labour market means that the time spent outside the labour market is growing in comparison with time spent in work.

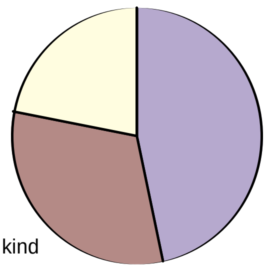
1.4. Pension expenditures place pressure on public finances

Ageing is expected to result in substantial increases in age-related public expenditures, which will be unsustainable without fundamental reforms.

CHAPTER 1: THE CHALLENGE

With almost half of the total social protection expenditures spent on pensions, pensions expenditures represent by far the largest share of public expenditure on social security in all EU countries (see chart 1 below).

Chart 1: Social benefits, EU-15, 1998
(as % of total benefits)



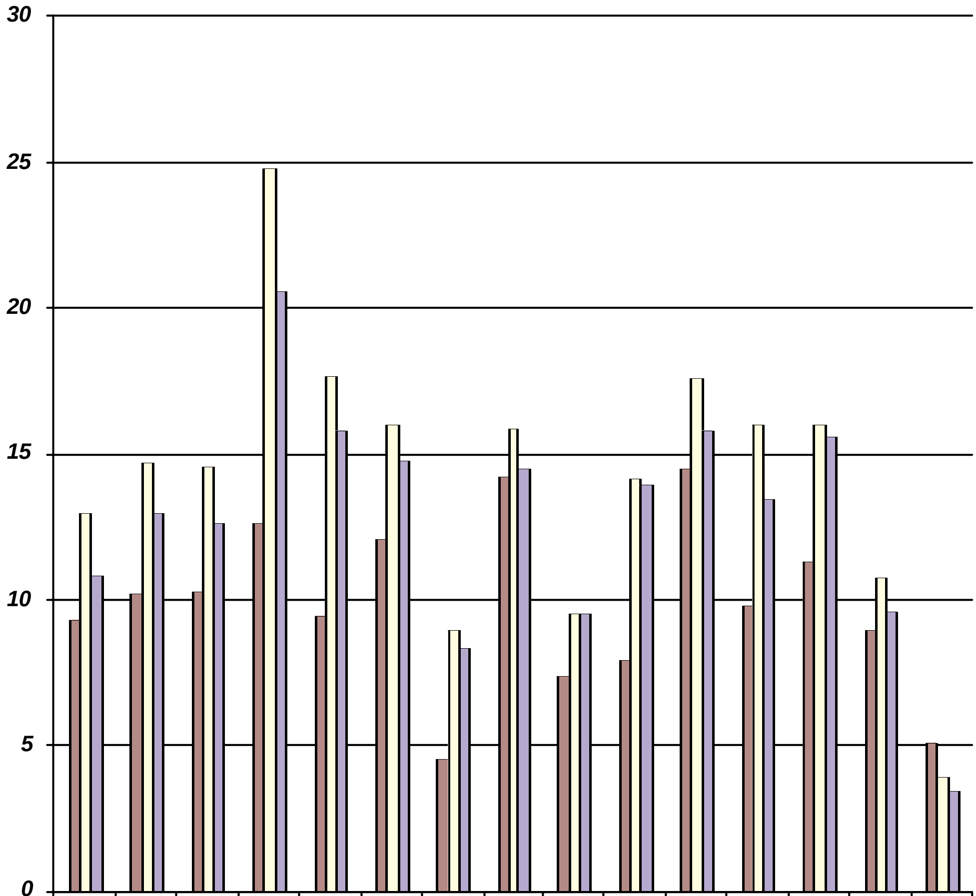
Source: Eurostat, Statistics in focus, 9/2001 "Social Protection: Expenditure on Pensions"
Benefits in kind: in-patient and out-patient care, accommodation for old or disabled people, day centres, etc.
Other cash benefits: family allowances, birth grants, death grants, unemployment benefits, vocational training allowances, paid sick leave, parental leave benefits, etc.

Chart 2 below presents long-term projections of the effect of ageing on public expenditures in the case of the continuation of the present policies compared with a scenario where the EU meets all the macroeconomic objectives set at the Lisbon Council. The projections were developed by the Economic Policy Committee based on commonly agreed demographic and economic scenarios, as well as specific assumptions by each Member State[1]. The peak year is the year over the period between 2000 and 2050 when the sharpest increase in expenditures will be registered.

1 For a description of the macroeconomic and demographic assumptions on which the pension projections were calculated in both scenarios, see annex

CHAPTER 1: THE CHALLENGE

Chart 2: Public pension expenditure projections[2] (as a % of GDP)



	B	DK	D	EL	E	F	IRL	I	L	NL	Os	P	FI	S	UK
2000	9,3	10,2	10,3	12,6	9,4	12,1	4,6	14,2	7,4	7,9	14,5	9,8	11,3	9	5,1
Peak year (current policy case)	13	14,7	14,6	24,8	17,7	16	9	15,9	9,5	14,1	17,6	16	16	10,7	3,9
Peak-year (Lisbon scenario)	10,8	13	12,6	20,6	15,8	14,8	8,3	14,5	9,5	13,9	15,8	13,5	15,6	9,6	3,4

Source: Economic Policy Committee, Progress report on the Impact of Ageing Populations on Public Pension Systems, November 2000.

[2] For Germany, figures refer to the statutory pension schemes, excluding the civil servants' scheme. For Greece, provisional data. For France, the figures include the compulsory supplementary schemes AGIRC and ARCCO. For Luxembourg, figures refer to the public pension schemes for the private sector and do not include the public pension schemes for civil servants and assimilated employees. For the Netherlands the occupational pensions pillar (second pillar) is well developed. This will have a direct positive impact on the public pension scheme by reducing the burden of ageing populations on state pensions. The United Kingdom also has well developed private pension pillars.

CHAPTER 1: THE CHALLENGE

In both scenarios, the public pension expenditures as a percentage of GDP is predicted to rise, but the magnitude differs substantially.

In the current policy case scenario, the rise will be more significant than in the Lisbon scenario. In more than half of the EU countries the peak demand will add 4.3 to 8.3% to pension expenditure.

When the more favourable (but also less realistic) Lisbon scenario is considered, projections show a maximum growth in pension expenditures lower by 2% than in the current policy scenario, with five countries nevertheless facing an increase in public pensions spending of more than 4% in the peak year.

However, when interpreting chart 2, one should bear in mind that in some EU countries (the Netherlands, United Kingdom and Ireland) private pensions form an important part of both current and future pensions (see table 4 below).

Table 4: Assets of pension funds in EU countries, 1996 (% of GDP)

Austria	1.2
Belgium	4.1
Denmark	23.9
Finland	40.8
France	5.6
Germany	5.8
Greece	12.7
Ireland	45
Italy	3
Luxembourg	19.7
Netherlands	87.3
Portugal	9.9
Spain	3.8
Sweden	32.6
United Kingdom	74.7

Source: OECD (1998)

1.5. SHARP INCREASES IN OTHER AGE-RELATED EXPENDITURES: HEALTH AND LONG-TERM CARE EXPENDITURES

The growing share of the elderly and substantial and sustained longevity growth do not raise only the question of higher pensions bills, but also the issue of sharp increases in other age-related expenditures and in particular the provision of health and long-term care needs.

However, the present paper concentrates on the issue of old-age pensions and other mechanisms resulting in early exit from the labour market.

1.6. PENSION SYSTEM SUSTAINABILITY IN AN ENLARGED EUROPEAN UNION

By the time the baby-boom generation of the 20th century draws on the pension systems, the EU will have new Member States. That implies that talking about long-term sustainability of pensions systems in the EU means in fact talking about the sustainability of pensions systems of the enlarged EU.

This represents a key dimension that has to be borne in mind when formulating strategies dealing with ageing population. Consequently, the future EU Member States should also pursue policies aimed at ensuring sustainability of pension systems upon accession to the EU and in the longer run. In this respect, the EU institutions and the current EU Member States have an important role to play during the enlargement process.

CONCLUSION

Europe is faced with an unprecedented economic and social challenge due to demographic change. The rise in the number of older people will be such that the increase in the demographic old-age dependency ratio can be halted neither by a sudden increase in fertility nor by any realistic level of immigration.

This evolution will result in substantial increases in age-related expenditure, which will be unsustainable and will lead to:

- **either a sharp increase in contributions, or**
- **a sharp decrease in benefits.**

This situation can be partly avoided if employment rates rise. However, the simultaneous phenomena of a drastic rise in the number of old people over the next decades and the shrinking young population will be of such a magnitude that more comprehensive and deep-rooted pension reforms are needed.

Finally, the fact that the phenomenon and its impact concern not only the current EU Member States, but also the future ones should not be overlooked.

CHAPTER 2: REFORMS IN THE EU MEMBER STATES

2.1. PENSIONS SYSTEMS: THE THREE PILLARS

2.1.1. First pillar

Funding

The biggest part of pension benefits in most EU countries are provided for by the public component of pension schemes, known as the first pillar. This component is in the majority of cases unfunded (**pay-as-you-go**-PAYG), with wage taxes levied on employees and employers to finance the pensions of current retirees. The back-up for the benefit promise is therefore the capacity to raise social security contributions in the future and the level of contributions.

However, in some public pension schemes, benefits are also financed to some extent through transfers from the **state budget** through general taxation. Denmark is the only country where public pensions are financed entirely from the state budget.

In 2 Member States (Finland and Sweden) the pensions are **partly pre-funded.** Part of the contributions is invested in special funds, which will be used to pay part of the pensions.

Benefits

In nine Member States[3] out of fifteen, public pension systems offer a universal pension scheme, in the form of a flat-rate pension providing a minimum standard of living for all pensioners. Most plans are made of a **mixed system with a flat-rate pension and an earnings-related component,** which aims at providing living standards comparable to those enjoyed during working life. In some Member States, pensions are entirely earnings-related.

Nature

Affiliation to the first pillar is compulsory for all employers and employees. In France, the first pillar is composed on the one hand of the legal regime of social security and on the other hand of supplementary pension schemes (AGIRC and ARCCO), of a contractual origin, but made compulsory for the whole private sector by law.

2.1.2. Second pillar

Defined benefit or defined contribution

The second pillar, private component of the pension schemes, refers to occupational supplementary pensions, which are usually organised on company or industry level. Contributions into the scheme are linked to salaries and the largest part of contributions are paid by the employer. In most cases[4], the employee also contributes. The share of the employer and employee' contributions vary from scheme to scheme and from country to country. Schemes can be of the **defined contribution** type or of the **defined benefit** type.

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[3] Denmark, Finland, France, Ireland, Netherlands, Portugal, Spain, Sweden and United Kingdom

[4] The exceptions mainly concern Germany and Sweden where most second pillar schemes are financed by the employer only.

Most second pillar pensions in EU countries are **defined benefit** schemes. In such schemes, the benefit to be paid at the pension date is guaranteed. The benefit amount is related to age, years of service and final average pay. The performance risk of the fund is for the employer or institution running the scheme. Contributions to the scheme can vary depending on the investment performance.

In five countries[5], second pillar systems totally or partially based on **defined contribution** schemes also exist and can represent a significant proportion of pensions. In such schemes the contributions are agreed. The level of the benefits received will depend on the level of individual contributions and of the funds' investment returns.

Nature

In the majority of EU countries, the second pillar is **voluntary** both in the public and private sectors. There are some major exceptions. In the Netherlands, employers are not legally bound to provide supplementary pensions for their employees, but when they do so and a sectoral pension fund is established, affiliation to this particular scheme usually becomes mandatory for all companies and employees of the sector concerned. In Denmark, it is mandatory for individuals covered by collective agreements to be affiliated to a scheme agreed between the employers and employees. The second pillar is mandatory for salary earners in the German public sector. In Finland, employers contribute both to the occupational pension schemes and to the personal pensions schemes subscribed by the individual employees (third pillar schemes). In the United Kingdom, the first pillar consists of the State basic pension and a supplementary pension scheme-the State Earnings Related Pension Scheme (SERPS). Both employees and employers make contributions to SERPS. It is possible to "contract out" of SERPS through membership of an occupational pension scheme or a personal pension scheme. Second pillar pensions are not compulsory, but employees have a financial incentive to join an occupational scheme through the contracting out arrangements. Employees who join an occupational pension scheme are automatically withdrawn from the state earnings related pension scheme, and pay reduced national insurance contributions.

2.1.3. Third pillar

The third pillar, private component of pension schemes, consists of **voluntary** supplementary pensions. It consists predominantly of life-insurance-based pensions. It is not financed by the employer but by the individual (except in Finland, where employers also contribute to these schemes). All third pillar schemes are individually **defined contributions schemes**.

[5] Belgium, Denmark, Ireland, Sweden and United Kingdom

2.2. REFORM MEASURES

Pension reforms have been a high priority on the political agenda in every EU country for almost a decade.

In all Member States, the process of reform is underway. While the measures introduced differ from country to country, all reforms seek both to limit transfers necessary in the future and to increase the finances available. However the way in which these two parameters have been modified is still insufficient in many Member States.

2.2.1. Reforming first pillar pension systems

Ageing of the population has an obvious significance for publicly run (PAYG) pension systems. Policy-makers have realised for some time that deficits on the PAYG system would soon reach unsustainable levels or contributions would reach prohibitive levels if no changes were introduced in terms of both benefits and contribution rates. But the practical obstacles to implementing reforms are substantial. A reversal from past trends is being introduced gradually and will take full effect in the long run.

In the following section we provide an overview of the main trends in reforming the public pension systems in the EU countries.

A. Increasing the legal retirement age: mostly for women as a measure implementing equal opportunities policy, not pension reform

Even though partial measures to increase the retirement age have been introduced in all Member States, they are still insufficient.

These measures have taken the form of either increases of the legal retirement age, mainly of women, or of increases in the contribution period necessary for drawing a full pension.

In most EU countries, the statutory retirement age has only been increased for women in order to correct gradually a difference between the legal retirement age of men and of women. This measure has been taken in order to implement the principle of equal opportunities and not as a pension reform measure.

A number of Member States also promote part-time working of older workers as a gradual transition to retirement (Belgium, Finland, Germany, Luxembourg, Spain, the Netherlands). This requires the possibility of combining earnings from work with pension benefits. However, this has a limited impact only, as flexible retirement is mainly taken up as an alternative to early exit from the labour market by people below the age of 60 or 65 and seldom after the legal retirement age.

Chapter 2: Reforms in the EU Member States

In almost all EU countries, 65 years will be the legal retirement age requirement for women and men in both the private and public sector. However, there are some noticeable exceptions to the 65 years rule, with legal retirement age in the public sector as low as 60 years in Portugal and 55 years in Greece. In France, the statutory retirement age for men and women is 60 in both the private and public sector but 55 in many special schemes.

In several countries the reforms also include an extension of the contribution period necessary for drawing a full pension and of the number of contribution years for being eligible for an old-age pension.

In the EU countries, the contribution period necessary to benefit from a full old-age pension usually ranges from 35 to 45 years. In France increasing the length of the maximum contribution period has been one of the main elements of the pension reform in the private sector. The period necessary to benefit from a full pension is being gradually raised from 37.5 years until 1993 to 40 years from 2003 onwards. However, no reform has been introduced for public sector. In Belgium the length for the whole career for women is being raised by 5 years (from 40 to 45 years) in order to equalise it with that of men, but this has been done in order to implement the principle of gender equality and not as a pension reform measure.

Increasing the contribution period necessary to qualify for a full pension should have an important impact, as it is likely to result in workers remaining longer in employment. However, there is clearly a need to further raise the retirement age in several countries and an urgency to tackle the situations where the legal retirement age is below 65.

B. Despite reforms, early exit from the labour market is still too easy

Three types of schemes open the way to early exit from the labour market in Member States:
- disability,
- unemployment,
- special early retirement schemes.

All countries have introduced changes in early labour market exit schemes. These reforms resulted in a variety of behaviours due to their diversity. Early exit from the labour market is still possible before the legal retirement age but:
- it is made more difficult by increasing the pre-retirement age or introducing flexible retirement with increased pensions rights for those working longer, or opening the way to progressive retirement with the possibility of combining earnings from a part-time work and pension benefits,
- stricter rules have been introduced for disability and unemployment schemes.

If one excepts Germany, early retirement is still possible before the age of 60 in all EU countries. However making use of this possibility will entail a reduction in the pensions benefits in a majority of situations.

In some countries, the early retirement age is lower in the public sector than in the private one. In the public sector, in Greece early retirement is possible at 55 for men and at an age as low as 42 for women hired before 1983 and in France at the age of 56 for both genders.

Another way of influencing behaviour with regard to early exit from the labour market is to increase the minimum contribution years required to qualify for a pension. However, the effect is likely to be marginal as this minimum contribution period is usually very low.

Two countries have introduced reforms with regard to minimum contribution periods of a magnitude which could influence individual behaviour. In Ireland, the contribution required for eligibility for an old-age pension is planned to be increased from 3 to 10 years by 2012. Since 1993, Italy's requirements for contributions in both the public and private sectors have gradually been increased and currently reach 20 years for those covered by the old system compared with 15 years initially.

There is clearly a need to take further measures to discourage early exit from the labour market and an urgency to tackle the situations where early retirement is still possible below 60. This is essential in order to increase the effective retirement age.

C. Lowering replacement ratios through redesigned benefit calculation and stricter indexation rules is only used as a marginal measure

One important aspect, which is often overlooked, is that demography alone is not responsible for the rise in pension expenditures. The excessive pension liabilities facing the European countries also result from generous pension policies. The generosity of public PAYG systems can be measured by the replacement ratio, i.e. what proportion of the last wage the pension benefit represents. Reduced replacement rates can be the result of changes in the benefit calculation formula and of stricter indexation rules.

The most common **change in the method of calculation of benefits** has been the broadening of the reference period. For instance, in France, a gradual lengthening of the reference period is underway to take into consideration the average salary from a period of the 25 best years from 2008 when the reform will be fully implemented instead of those from the 10 best years until 1993 and 17 years under current rules. Nevertheless, for the public sector, the period of reference is the last six months of employment. In Sweden, under the new pension system, the level of the public pension is determined by a person's lifetime earnings, and not by the 15 best earning years as in the past.

In Belgium, the increased contribution period for women is reflected in the calculation formula. However, the savings made will be partly offset by higher spending on unemployment, early pensions and invalidity: women will be able to benefit from these social security regimes for an additional five years.

Stricter indexation rules can also result in a lower replacement rate. The indexation rules preserve the real value of the pension income. If it is indexed to wages, the retirement income will make it possible to maintain, relatively, the living standards. If it is indexed to prices, purchasing power is preserved.

In the EU France, Italy, Luxembourg, Spain and United Kingdom index pensions to prices. Denmark and Germany use indexation to wages. The other countries use a mixed indexation or ad hoc systems. For example, Sweden uses a mixed system linking pensions indexation to wages and GDP growth.

Positive measures to moderate pension expenses have been introduced in Belgium with the progressive elimination of the “well-being” indexation, which was granted over and above price indexation – for calculation of certain pensions. However, this was largely offset by the institution of a minimum right per year of contribution for low-paid workers and by the decision concerning workers whose pay is above or equal to a ceiling indexed against prices, to adapt the ceiling every two years to reflect real pay increases above price increases.

In Germany, the recent pension reform introduced ways of moderating indexation related to wages. As a result of this, the net pension income will decrease to 67% of average net working income by 2030 compared with 70.7% in 2000. A correction factor has been introduced to the effect that pension adjustment lags behind wage increases.

Changes in the method of calculation of pensions benefits are moving in the right direction. However, there is a clear need to further reform indexation mechanism in many Member States to ensure sustainability of pensions.

D. Measures to pre-fund future liabilities can be part of the solution

Within the first pillar, several Member States have introduced a funded component, which means that part of the pensions will be paid out from special funds.

Belgium, France, Luxembourg, Portugal, Spain and the Netherlands opted for the creation of reserve funds, included in national budgets, to be used in the periods during which demographic ageing will put particular strain on pension systems. The money allocated to these funds comes notably from savings in interest rate expenditure resulting from debt reduction, or from budget surpluses. Ireland has also created a fund aimed at stabilising State and public service pension costs until 2055, funded by allocation of 1% of GNP each year directly from the Exchequer.

Finland and Sweden have a first pillar composed of a PAYG component and a pre-funded component, that means that part of the contributions to the public pension systems are deposited in special funds and are invested. These funds are not included in the national budget. Future pension benefits are partly financed from a PAYG component and partly from the assets and the returns on investments of the funded component. In Sweden out of the 18.5% contribution levied on workers and employers, 2.5% is deposited in such funds. In Finland, the 10 existing earnings-related pensions schemes are pre-funded in a similar way, but the amount of contributions varies from scheme to scheme.

Preparing for the unprecedented demographic change through fiscal consolidation is essential and pre-funding future pension liabilities can be part of the answer to the pension challenge, in so far as it can ease the financial pressure during periods when demographic ageing will put particular strain on pension systems. Nevertheless, the disadvantage is that, in the case of reserve funds, there is a risk that outlays will provoke

or will increase budget deficits once all the sums set aside are used. Moreover, pre-funding alone does not address the structural causes of pensions deficits and should therefore only be used in combination with structural reforms of pension systems.

2.2.2. Measures to develop second pillar pensions (occupational pension schemes)

The development of second pillar pension schemes requires encouraging employers and workers to invest in such schemes. The most widely used incentive measures are relief on income taxation or corporate taxation. However the level of taxes levied on benefits also influence the attractiveness of occupational pension funds for employees. Finally, prudential rules and taxation of investment returns are key factors since they determine the funds' performance and ability to generate attractive benefits.

There is also a European dimension to the taxation of occupational pensions as the differences in national regimes constitute an important obstacle to cross-border mobility of workers and can lead to situations where employees are taxed twice (on contributions and on benefits).

A. Tax incentives

In 10 Member States (Austria, Belgium, Finland, France, Greece, Ireland, Portugal, Spain, the Netherlands and United Kingdom) out of 15, the benefits only are taxed. In the majority of these countries, employee and employer contributions are tax-deductible within certain limits. Only Germany has a mixed system of taxation of either contributions or benefits depending on the characteristics of the occupational pension regime. Denmark, Italy and Sweden tax both investment returns and benefits. In Luxembourg taxes are levied on contributions only.

Germany has increased the ceiling under which the contributions are tax-deductible. Italy has introduced similar measures and taken other steps to ease the conditions attached to tax relief. In Sweden, deductibility of contributions has been extended to all types of supplementary pension schemes, regardless of their characteristics (defined benefit, defined contribution, funding requirements).

In order to encourage the development of second pillar pension schemes it is essential to ensure attractive fiscal incentives. Deductibility of contributions is the key element and investment returns, which is the basis of future benefits must not penalised. Double taxation for migrant workers is one of the main obstacles to mobility in EU and should be addressed.

B. Prudential rules applied to second pillar schemes

Occupational pension schemes are managed by various types of institutions. In many cases, this is done by pension funds or life insurance companies which invest the money in different types of assets. National regulations lay down statutory requirements to protect employee pension entitlements by imposing investment restrictions on certain types of securities, countries or geographical zones, currencies, sectors of activities, etc.

In Austria, Germany, Luxembourg and Sweden, companies themselves can run the scheme through **book reserves**. In this case, the benefits are paid by the employer directly to the employee from company funds. For this purpose the employer sets up provisions in the balance sheet. The capital accumulated remains within the company and there is no legal separation of assets. Investments of the companies are not subject to restrictions, but the company has to insure against insolvency (except in Luxembourg). In Germany and Luxembourg the book reserves system is the form of pension provision most widely used.

Unnecessary rules of a supervisory nature can also have a negative impact on the development of occupational pension schemes. In Spain, the pension plans and pension funds are subject to the control of committees involving representatives of the plan's promoter (employers) and beneficiaries (workers) which can intervene in the funds investment decisions and therefore discourage a wider use of the supplementary pensions schemes.

Measures to loosen the investment restrictions have been taken in two countries only (Belgium and Denmark).

In some EU countries, investment rules go beyond what is necessary to ensure the pension funds' prudential soundness. Freedom of investments is essential as the level of pension received (in case of defined contribution schemes) or the level of contribution (in the case of defined benefit scheme) depends on the investment performance. This is why a qualitative approach to investment rules (prudent person principle) should be applied rather than quantitative requirements or unnecessary restrictions of a supervisory nature.

C. Acquisition and transferability of pension rights

Adequate transferability of entitlements is important in order to make occupational pensions attractive and to promote labour mobility. Key obstacles to cross-border mobility have been lifted as a consequence of the adoption of the directive on the protection of occupational pension rights of workers making use of their right to free movement of workers. However, excessively long vesting periods or imposition of high minimum age requirements in Member States can be an obstacle to the development of the second pillar.

During the vesting period, employees leaving the schemes lose their entitlements to benefits. Three countries (Denmark, Germany and Italy) currently have both vesting periods and conditions relating to a minimum age.

Vesting periods differ widely from country to country and even within the same country between schemes. Denmark has a nine-month vesting period, Belgium and the Netherlands impose a one-year vesting period. In the United Kingdom, and under current proposals in Ireland, vesting periods last for 2 years and in Italy and Germany for 5 years. In Sweden, immediate vesting is a statutory requirement and in Austria, Finland and Spain it is provided for on a discretionary basis. In some countries (France, Greece and Portugal), there is no statutory maximum vesting period, that means that workers may have to be present in the company when they retire in order to be able to claim a pension. However, in Greece the vesting period usually lasts for 5 to 10 years and in Portugal for 10 years. In Luxembourg this period is of maximum 10 years.

In Germany a reduction of the vesting periods has taken place. Germany used to have the longest vesting period: 10 years, or 3 years with 12 years in-company service but it has been recently shortened to 5 years. The minimum age required has been reduced from 35 years to 30 years.

Vesting periods are necessary in order to avoid excessive fragmentation of supplementary pension rights and excessively burdensome administration. The duration of adequate vesting periods inevitably depends upon the nature of the fund concerned. However, excessively long vesting periods dating back to the days of lifelong careers with the same employer have to be reconsidered, bearing in mind the higher costs entailed and the possible need to introduce compensating tax measures.

D. Streamlining second pillar to allow individual savings for pensions

A developed second pillar of the pension system can help alleviate the future ageing pressures on public expenditure. However, it is crucial that second pillar pension schemes provide pensions as efficiently as possible and pursue a sound expenditure policy. If second pillar pensions do not keep employees' contributions at an affordable level, there is no room left for individual contributions to personal pension schemes. Some streamlining of second pillar pension schemes may be necessary in particular in those countries with a well developed second pillar.

2.2.3. Measures to develop third pillar pensions (individual pension schemes)

Third pillar pension schemes are an important factor for decreasing pressures on first and second pillars. However, individual pension schemes will only develop if conditions are attractive for people to set money aside for their retirement.

The main tools for promoting the development of the third pillar pension schemes are:
- developing the market for third pillar pension schemes;
- tax incentives for individuals to enter such personal pension arrangements;
- removal of cross-border tax discrimination;
- information and awareness-raising campaigns for individuals.

Generally the personal pension schemes are provided by life insurance companies and sometimes by pension fund management companies or banks. In the majority of EU countries premiums are tax-deductible under certain conditions.

A. Tax incentives

Germany, Ireland, Italy and United Kingdom have introduced fiscal incentives for individuals contributing to a personal pension scheme.

In United Kingdom a new form of personal pension called stakeholder pension was introduced in April 2001. From October 2001 employers are required to offer access to a stakeholder pension for their employees. This entails designating a stakeholder scheme (typically run by an external provider) and deducting and passing on employee contributions though the payroll where employees so request.

In Ireland, major reforms are being introduced to establish a simple flexible form of retirement plan for all earning levels and for any person, whether at work or not. These plans can allow for transfers from previous employment. These plans are intended to result in a streamlining of personal and occupational schemes and achieve increases in private pension coverage. They are also likely to be suitable for mobile workers and can be provided for by pension companies in other Member States. Any employer without an occupational scheme must choose one of these plans and facilitate deduction of contributions from salary, although the company does not have to contribute itself. These plans must be chosen from providers with charges below a certain limit to ensure good value.

B. Address obstacles to cross-border mobility of workers or to cross-border provision of services

Differences in national fiscal regimes constitute an important obstacle to cross-border mobility of workers as they can be taxed twice (on contributions and on benefits).

Moreover in some countries, a less favourable tax regime applies to life insurance companies or pension funds when providing third pillar pensions to non-residents than when offering services to residents. This type of discrimination should also be removed.

CONCLUSION

In all Member States, pension reforms are underway. While the measures introduced differ from country to country, all reforms seek both to limit transfers necessary in the future and to increase the finances available. However the way in which these two parameters have been modified is still insufficient in many Member States.

Regarding the public pension system, there is a clear need to increase the effective retirement age. Existing possibilities of retiring before the age of 65 with a full pension and the situations where pre-retirement is still possible below 60 should be addressed. Further reforms of the indexation mechanisms of pensions and pre-funding of future liabilities can also be part of the solution.

Regarding the development of second pillar pension schemes, it is essential:

- **to ensure attractive fiscal incentives,**
- **to remove double taxation for migrant workers,**
- **to remove unnecessary restrictions on investment decisions and apply the prudent person principle,**
- **to ensure adequate transferability of pension rights,**
- **to pursue a streamlining policy, if necessary.**

CHAPTER 2: REFORMS IN THE EU MEMBER STATES

Regarding the development of third pillar pension schemes, it is important to keep employees' contributions to first and second pillars at an affordable level, in order to make room for individual contributions to personal pension schemes. The main tools for promoting the development of the third pillar pension schemes are:

- **developing the market for third pillar pension schemes;**
- **tax incentives for individuals to enter such personal pension arrangements;**
- **removal of cross-border tax discrimination;**
- **information and awareness-raising campaigns for individuals.**

CHAPTER 3: RECOMMENDATIONS

The competitiveness of European companies, growth and employment in Europe are in danger if firms and workers have to cope with increasing labour costs due to a rising pensions bill. Reforms are underway in all EU countries. However more comprehensive and deep-rooted measures are needed.

Member States face similar challenges. However, it is essential to remember that there is no single European model of pension system. A “one size fits all” solution is neither desirable nor appropriate or feasible across the EU. The different systems reflect the political, cultural and economic diversity of the national states in which they have evolved. Reforms involve difficult decisions on the financing and coverage of social protection. These decisions must be tailored to the specificities of each system. They require building a new consensus around the solutions found. Even though they all involve acting on the same elements (retirement age, benefit coverage, incentives to the development of second and third pillar, etc.), the way in which these various elements have been modified varies. Finally, all Member States are not at the same stage of reform.

It is only within Member States that players will be able to choose the appropriate mix of measures and to build the necessary consensus around new economically efficient and socially acceptable solutions.

The primary responsibility of Member States does not mean that there is no EU dimension to pension reform policy.

Firstly, the exchange of experiences on solutions is extremely valuable at the EU level.

Secondly, ensuring free movement of people and labour requires the removal of obstacles to pension rights transferability and, in particular, of cross-border tax obstacles and barriers to cross-border provision of supplementary pensions across the EU. This is essential especially in the context of a growing share of the second and third pillar pension schemes.

Thirdly, delaying reforms can lead to a lack of credibility in one country’s budgetary policy, which can reduce the credibility for the euro zone as a whole. In addition, the increased debt in individual countries resulting from the pension bill may result in higher interest rates throughout the euro zone. Stability in the euro-zone therefore justifies some co-ordination of the national strategies for pension reform at EU level.

Reforms must be implemented across a broad front involving Member States and EU institutions. Pensions reforms, which remain a national responsibility, should be complemented with actions at the EU level. Actions should focus on measures aimed at improving flexibility of the labour markets and mobility of the workforce, ensuring long-run macroeconomic stability as well as adequate and sound social protection systems. Appropriate financial market reforms will make a significant positive contribution to this process. Promoting sustainability of the pension systems through the open method of co-ordination at the EU level is the appropriate approach.

CHAPTER 3: RECOMMENDATIONS

3.1. RECOMMENDATIONS FOR MEMBER STATES

Reforms should result in affordable systems with a better balance between the three pillars of the pension systems and between the collective and individual responsibilities within each pillar.

The appropriate role of the different pillars and the adjustment of the responsibilities within each pillar will depend on the prevailing pension systems and the reforms already undertaken, as well as the economic and social context of the individual countries. There cannot be a common solution for all EU countries. Nevertheless, pension systems should be built on a solid and sound public pension pillar, which should be complemented by suitable additional pension arrangements.

However, it is essential for national authorities to ensure that any changes to the current system will not lead to mandatory additional costs for employers so as not to damage the economic growth prospects.

To facilitate social acceptance of economically viable solutions, reforms should involve a variety of measures.

A. Reform parameters of the public pension systems

Keeping older workers in employment for longer is necessary to improve the economic dependency ratios.

On the revenue side, Member States should, where necessary,

- further increase contribution periods and/or the legal retirement age,
- urgently remove existing possibilities of retiring before the age of 65 with a full pension,
- discourage early exit from the labour market and address the situations where pre-retirement is still possible below 60,
- provide incentives to remaining active on the labour market beyond the standard retirement age and allow for a gradual retirement.

On the expenditure side, Member States should:

- improve the link between benefits and contributions by extending the reference period used to calculate the pension or by reducing replacement ratios directly,
- avoid indexation mechanisms which lead to automatic cost increases.

B. Increase the margins available for public pension systems

There are very good reasons to include **budgetary consolidation** among the key actions required to address the challenges of an ageing population. Firstly, budgetary consolidation should entail a focus of public expenditure upon priority areas. Living up to commitments towards future retirees is clearly a priority. Secondly, it creates conditions for lower long-run interest rates; greater macro-economic stability and lower debt levels both favour lower long-run interest rates. This is conducive to higher economic growth and employment, thereby increasing the overall capacity for financing social security and in particular pensions. This will limit the costs of financing future pension liabilities for governments.

Experience has shown that budgetary consolidation is more likely to be durable when it is based upon reforms of expenditure, as opposed to tax increases - which are not sustainable in the long run. Member States therefore should demonstrate their commitment to genuine budgetary consolidation by undertaking an effective reform of public expenditure. If suitable action is not taken now, EU countries will not be able to re-create the necessary margins to finance pension liabilities in the future.

Member States should be making further efforts to secure the financing of future pension liabilities; they could also set aside sums of money which are solely dedicated to pension expenditures during the expected peak years. Transparency is essential for the credibility of such measures. These sums should be clearly earmarked and their use should be strictly limited to the payment of future pension liabilities, rather than forming only a notional element of national budgets.

C. Encourage the development of private pensions

Governments should take measures aimed at improving both access to and performance of second and third pillar pension funds.

In order to improve access to second pillar occupational pension schemes, Member States should:

- provide fiscal incentives, mainly through relief on income taxation for workers and on corporate taxation for employers;
- reduce social security contributions and non-wage labour costs to create room for the development of such private schemes;
- look into transferability of occupational pension rights for workers changing jobs. Excessively long vesting periods or unnecessary conditions regarding minimum age for the acquisition of these rights should be lowered where necessary, bearing in mind the higher costs entailed and the possible need to introduce compensating tax measures.

In order to improve access to third pillar individual pension schemes, room should be left for individual contributions to personal pension schemes by keeping contributions to first and second pillar pension schemes at affordable levels.

CHAPTER 3: RECOMMENDATIONS

Member States should:

- create the conditions for the development of the market for third pillar pension schemes;
- provide tax incentives for individuals to enter such personal pension arrangements;
- remove cross-border tax discrimination;
- support information and awareness raising campaigns for individuals.

The performance of private pension schemes – be it in the second or third pillar – is a key element, since this will determine the level of contributions and benefits. Improving performance pre-supposes achieving higher rates of return on investments by the fund.

Member States should:

- replace quantitative constraints on investment decisions by pensions funds with the qualitative prudent person principle,
- increase competition between supplementary pension funds to improve their performance, including by opening their markets to foreign operators.

3.2. RECOMMENDATIONS FOR THE EU LEVEL

As explained earlier, the fact that pension reform is primarily a national responsibility does not exclude EU level action on this crucial issue. National reforms should be underpinned and complemented by relevant measures at the EU level in two ways:

- by ensuring some coordination of national macro-economic, employment and pension reform policies,
- by taking the necessary measures to complete the internal market in financial services and addressing cross-border mobility issues.

3.2.1. With regard to coordination of national policies

A. Include a clear strategy for dealing with ageing population in the BEPG

As explained in the previous section on measures to be taken in Member States, economic policy coordination should aim at long-term stability of public finances. The Broad Economic Policy Guidelines defined at EU level – which provide the overall framework for national policies – disappoint by their failure to present a clear strategy for dealing with the ageing of population. The long-term soundness of public finances should be more explicitly included as a policy variable within the Broad Economic Policy Guidelines and the Stability or Convergence programmes, so as to improve the monitoring of progress in this area.

B. Promote efficient and flexible labour markets through the European employment strategy

The ageing population also means a considerable reduction in labour supply, as the working-age population declines. This highlights the importance of improving the overall functioning of labour markets. Most of the necessary reforms in this area will have to be taken in Member States. However, the EU also plays a central role since the adoption of a European employment strategy. It is essential that this strategy acts as a catalyst for change.

Employment guidelines address the main challenges for improving the functioning of labour markets characterised by an ageing workforce. However, reports on national implementation show that real progress is lagging – excessive indirect labour costs (which is particularly relevant for older workers) and early exit from the labour market remain crucial problems for many Member States to address.

Increases in the old-age dependency ratio cannot be halted by any realistic level of migration. However, availability of labour from third countries through a more open EU immigration policy is also part of the answer. Such a policy can address bottlenecks and help alleviate the adverse effects of the ageing population on pension systems.

C. Monitor the evolution of national pension reforms

Stability in the euro-zone justifies some co-ordination of the national strategies for pension reform at EU level. However, this co-ordination must fully respect the specificity of this policy area.

In contrast to budgetary policy, which evolves with the economic cycle, and employment policy, which has medium-term objectives, pensions reform occurs within a very long-run perspective.

The objectives defined for the purposes of monitoring pension reforms at EU level should aim at very long term. However, they could be implemented through national action plans covering a medium term, for example of three years. Nevertheless, an annual report on social protection highlighting the main national reforms could be extremely useful to keep the momentum for reform.

With regard to the content of the objectives of pension reform, UNICE would like to highlight that the diversity of pension systems will make it very difficult to go beyond very general orientations with little direct operational relevance. While recognising that pension systems fulfil both social and economic objectives, given the demographic trends, UNICE insists that policy orientations defined at EU level fully reflect the fact that economic sustainability should be the main aim of reforms.

With regard to the monitoring of national reform measures, employers insist that it should not exclusively focus on the reform of first pillar but should also assess the development of second and third pillar schemes.

CHAPTER 3: RECOMMENDATIONS

3.2.2. With regard to cross-border mobility

Liberalise cross-border provisions of supplementary pension funds and remove obstacles to cross-border mobility of workers.

The investment choices of pension funds should be liberalised; the unnecessary investment rules – which impose quantitative restriction upon investments – should be replaced by the qualitative principle of the “prudent person” across the Union. This would lead to a marked improvement in the performance of pension funds. The benefits would accrue to both employers and employees. Furthermore, allowing pension funds to operate across the Union as a whole, would represent an important move towards the creation of a single market for supply of pension services in the Union, and would allow multi-national companies to organise the pension schemes for all their European employees on a central basis, entailing considerable cost savings.

The proposed directive on the activities of institutions for occupational retirement provision should be adopted and implemented as soon as possible to facilitate cross-border provision of pension funds and mobility of workers.

Adoption of this directive would also represent a significant step towards creating a single market for capital. At the moment, the market for capital remains fragmented. Pension funds account for a substantial share of total funds invested. By removing unnecessary constraints to their cross-border operations, the performance of the economy as a whole would benefit, creating a win-win-win situation, that benefits employers, employees and the wider economy as a whole.

Individuals changing country also face the risk of tax penalties, which act as a severe disincentive to cross-border mobility. Double taxation for migrant workers is one of the main obstacles to mobility in EU and should be addressed. The removal of these tax obstacles can be achieved by enshrining the EET principle (exempt, exempt, taxed) in taxation law throughout the EU. The promotion of the EET principle across Europe is also fully consistent with the aim of encouraging the development of second and third pillar pension systems since individuals will be more inclined to make contributions if these are are tax-exempt.

CONCLUSION

Europe is faced with an unprecedented economic and social challenge due to demographic change. The rise in the number of older people will result in substantial increases in age-related expenditure, which will be unsustainable and will lead to either a sharp increase in contributions, or a sharp decrease in benefits unless appropriate reforms are introduced.

Reforms are underway in all EU countries but a more comprehensive and deep-rooted approach, acting on several fronts and involving a broad range of actors is needed. There is no single European model of pension system. It is only within the Member States that the appropriate mix of measures can be achieved and the necessary consensus around economically efficient and socially acceptable new solutions can be built. Reforms in the Member States should involve a variety of measures including:

- further reforming the parameters of the public pension systems;
- increasing the margins available for public pension systems through budgetary consolidation;
- encouraging the development of private pensions.

However, the primary responsibility of Member States does not mean there is no EU dimension to pension reforms policy. National reforms should be underpinned and complemented by relevant measures at the EU level in the following ways:

- by ensuring coordination of national macro-economic and employment policies;
- by taking the necessary measures to complete the internal market in financial services and addressing cross-border mobility issues;
- by monitoring the evolution of national pension reforms and some co-ordination of the national strategies for pension reform at EU level.

ANNEX

ECONOMIC POLICY COMMITTEE PROGRESS REPORT ON THE IMPACT OF AGEING POPULATIONS ON THE PUBLIC PENSION SYSTEMS

Main macroeconomic and demographic assumptions for the projections of public pension expenditure over the period 2000-2050 in two different scenarios

Macroeconomic assumptions

- **Current policy scenario** assumes non-implementation of structural reforms decided by the European Council in Lisbon. Unemployment rates fall to their structural level in each Member State and annual productivity growth in Member States converges to 1.75 % during the period 2020-2030.

- **Lisbon scenario** assumes that following implementation of the reforms decided in Lisbon, male and female participation rates will gradually converge to 83% by 2045 and their unemployment rates will converge to 4% by 2045 and that EU countries will also witness convergence of their productivity to the most competitive levels in the world (i.e. the level and growth registered in the US by 2050 where annual productivity growth is assumed to be around 1% on average in the first half of the current century).

Demographic assumptions

For both scenarios, demographic assumptions for public pension projections were provided by EUROSTAT.

- **Current policy scenario** uses the mean-variant (or central) demographic projections. They show that starting from around 2020 the EU population is expected to decline, due especially to low fertility rates. By 2050 the population may be more than 3 per cent lower than the current level.

- **Lisbon scenario** uses the high-variant demographic projections (except for Portugal which uses the mean-variant scenario). These differ from the mean-variant because they assume higher fertility rates, higher life expectancies at birth and higher net migration levels. In this scenario, the EU population is expected to increase by around 17 per cent from now to 2050.

However, it should be noted that not all Member States followed these macroeconomic and demographic assumptions exactly and such divergences make direct cross-country comparisons more difficult.

NOTES

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