

PERSPECTIVE

Vol. 3 / No. 4

August 1997

Perspective is a series of occasional papers published by the Investment Company Institute, the national association of the American investment company industry.

Paul Schott Stevens,
executive editor;
Sue Duncan,
managing editor.

1401 H Street, NW
Suite 1200
Washington, DC 20005

Selected Issues in International Taxation of Retirement Savings

presented by
Paul Schott Stevens
Senior Vice President and General Counsel
Investment Company Institute¹

to the Organization for Economic Cooperation and Development (OECD)² Committee on Financial Markets at the July 7-8, 1997 meeting on "Institutional Investors in the New Financial Landscape." The paper observes that the global shift toward funded retirement plans—both government-sponsored or mandated plans and employer-sponsored occupational-based plans—will be more successful if plan assets are invested effectively, both domestically and internationally. One tax impediment to the effective international investment of retirement plan assets is the tax generally imposed on nondomestic retirement plans by the country in which the plan assets are invested (the "source country"). The paper concludes with the Investment Company Institute's proposal that countries adopt, on a reciprocal basis, source-country exemptions from tax for retirement plan assets.

SUMMARY

The global demographic shift towards an aging population threatens the ability of many governments to sustain the government-sponsored "pay-as-you-go" retirement plans that historically have been a central pillar of their retirement systems. Countries are thus turning to funded retirement plans—both government-sponsored or mandated plans and employer-sponsored occupational-based plans—as an important component of a system for providing retirement security for their citizens.

Essential to the success of funded retirement plan systems is the effective investment of plan assets. Retirement plans should have the ability to seek investments, including international investments, which offer prudent diversification against risk and the highest rates of return consistent with the goal of preserving a fund sufficient to pay future benefits. Taxation of the earnings of retirement plans by the country where the assets are invested (the "source country")—when plans generally enjoy exemption from tax in their home country—is a significant disincentive for international investment of retirement plan assets.

¹This paper was prepared for the Institute by Stephen E. Shay from the Boston law firm of Ropes & Gray, with assistance from the Institute's Catherine L. Heron, Vice President and Senior Counsel, Keith D. Lawson, Associate Counsel – Tax, and Mary S. Podesta, Associate Counsel – International.

²*Editor's Note:* The OECD, which is organized to promote economic growth, financial stability, and expanded world trade, has 29 member nations: Austria, Australia, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, New Zealand, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

An appropriate solution to this disincentive would be the adoption of reciprocal tax exemptions from source taxation for the investment earnings of retirement plans that are exempt from taxation in their home country. Reciprocal source-country exemptions from tax for retirement plan investment income would make the decisions where to invest retirement plan assets “tax neutral” as between the source and residence country and would support the tax and retirement security policies of both countries.

This paper urges the OECD to consider a specific proposal to exempt retirement plan investment income from taxes imposed by the country where the assets are invested if the retirement plan’s investment income is exempt from tax in the country where the plan is resident. The proposal would further the general tax policy of making decisions where to invest retirement plan assets tax neutral and thereby enhance the accumulation of retirement savings and increase benefits to beneficiaries. In addition, international investment of retirement plan assets benefits the economies of the countries where the beneficiaries are resident and the retirement plan assets invested.

BACKGROUND

The world’s population is aging. Declining birth rates and the growth and widespread dissemination of medical knowledge extending longevity are resulting in a demographic shift, with a growing portion of the global population consisting of individuals in their later years. In 1990, almost half a billion people were over age 60, making up nine percent of the world’s population. This number is projected to reach 1.4 billion people in 2030 or 16 percent of the world’s population. Among the group of countries that are members of the OECD, these percentages are projected to increase even more dramatically, from approximately 18 percent in 1990 to nearly 31 percent in 2030.³

The impact of this demographic shift is already being felt in the retirement systems of OECD member states.⁴ A central feature of the retirement systems of most OECD countries has traditionally been,

and so far continues to be, a government-sponsored defined benefit system, providing a minimum level of retirement income to retirees. These are typically “pay-as-you-go” systems, under which the pensions of retirees are paid for by current workers through payroll taxation. The demographic shift toward an aging population (coupled with moderating real wage growth) has already begun to cause serious funding problems with these schemes. Very simply, a shrinking population of workers will be required to fund an ever increasing number of retirees with increasing life expectancies. As this demographic shift becomes more pronounced, these systems will become more difficult to sustain in the future. Maintaining a level of benefit for future retirees that is comparable to current levels would require governments to raise payroll or other taxes. An increased payroll tax burden will distort and impair labor markets already facing disruptions associated with the demographic shift. Moreover, “fairness” concerns about the extent of such an intergenerational wealth transfer will no doubt increase, especially among people currently working who have diminishing expectations that they will, in turn, be the beneficiaries of such a transfer in their retirement years.

Faced with this problem, there is an emerging consensus that there should be increased reliance on funded retirement plans as a supplement to, or even substitute for, pay-as-you-go retirement security systems. Under a funded plan, assets are set aside or segregated from general assets and

³For a more complete description of the anticipated demographic shift, as well as specific demographic analyses, see *The World Bank, Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth* (Oxford Univ. Press, 1994), Chapter 1 (the “World Bank Report”).

⁴See Borenberg and van der Linden, “Pension Policies and the Aging Society,” *The OECD Observer*, No. 205, 10-14 (April/May, 1997).

invested, with the intention that these assets be used solely for the purpose of meeting future benefit obligations to current workers. For government plans, this generally provides greater security for future benefits and, by greater reliance on investment return, reduces the need to rely on future increases in taxes. Moreover, in a government scheme following a “defined contribution” model (under which an individual’s future benefits are based on amounts contributed on his or her behalf and the earnings thereon), payroll “taxes” can be replaced by, or at least recharacterized as, contributions which the worker will reap in the future.

The trend for occupational, employer-based plans has been toward use of funded contribution plans. These plans provide greater security for beneficiaries and are less vulnerable to enterprise risk of the employer. Furthermore, where private, occupational-based plans are preferred, funded plans are uniquely amenable to providing tax incentives to induce employers to adopt and maintain them. Many OECD countries rely on private, funded retirement plans as an important pillar of their retirement systems.⁵ Funded plans generally are less distortive of savings decisions and labor supply because they do not require risk sharing and income redistribution.

As described in more detail in the appendix, retirement plans are typically divided into two major categories: “defined benefit” plans and

“defined contribution” plans. Defined benefit plans are generally thought of as the classic “pension” plans, under which a benefit, determined by formula, is paid periodically, generally for the balance of a retiree’s lifetime. Under a defined contribution model, a retiree’s benefits are based, not on an established formula, but on the amount of contributions made to the plan for the retiree’s benefit during his or her working years, adjusted for investment gains or losses until actually paid. Most government-sponsored retirement security plans are defined benefit plans. In pay-as-you-go plans, these benefits are financed currently out of a country’s budget. Under a funded defined benefit scheme, the government’s future benefits obligations are projected, based on actuarial and economic assumptions, and assets are segregated in a trust fund, or similar arrangement or account, to fund future benefits.⁶ Under government-sponsored defined contribution plans, a payroll tax would essentially be replaced by a scheme of government-mandated contributions under which a percentage of a worker’s earnings (or, less likely, a fixed amount) is paid into a fund and credited to an individual account maintained for the worker’s benefit. A government-mandated contribution scheme under which workers direct the investment of their own accounts was first adopted on a large scale in Chile and is now being introduced in a number of other countries worldwide.

Private employer-based plans fall into the same two general categories of defined benefit and defined contribution plans, but have a number of notable differences. For both types of plans, the worker’s benefit under an employer’s plan generally depends on the worker’s service history with the employer. The ultimate benefit will be based, in some fashion, on his or her earnings history and length of service with the specific employer. Under a private scheme, a worker’s benefits are “career” benefits like those of a public pension scheme, but in this era of mobile labor markets and high worker turnover, the “career” benefit may be the product of a number of separate

⁵Denmark, the Netherlands, New Zealand, and Switzerland are perhaps the leading examples of OECD countries where private funded schemes now play a significant role in providing income insurance for the elderly. Laws establishing compulsory and quasi-compulsory provision of occupational pension plans on the part of employers in these countries have helped to reduce the burden on the public retirement security systems. In countries like Japan and the UK, meanwhile, provisions which allow employers to contract out of public plans by meeting certain requirements for privately funded schemes are increasing the role of occupational plans. In contrast, countries such as Germany, France, and Italy continue to rely heavily on a single, comprehensive public pension system for both old age income insurance and poverty alleviation. See the World Bank Report, pp. 168-169, and Borenberg and van der Linden.

⁶Many existing government-sponsored defined benefit plans are partially pay-as-you-go and partially funded.

employers' plans. This is significant because, for the most part, OECD countries do not require employers to adopt their own plans or impose standards for minimum benefits. A worker's retirement income under a private system will depend on the existence and generosity of his or her former employers' plans, which, in turn, will likely depend on the success of the government's policy to induce employers, through incentives, to adopt retirement plans.

The remainder of this paper describes the domestic tax treatment of funded retirement plans and the international taxation of their investment income. As described below, source taxation of retirement plan international investment income imposes significant obstacles to international investment by retirement plans and thus undermines the retirement security policies underlying funded plans. This paper concludes that reciprocal exemption from source taxation for retirement plan investment income is an appropriate solution to remove these obstacles and help foster secure retirement income and savings through tax-neutral global investing.

DOMESTIC TAX TREATMENT OF RETIREMENT PLANS

Generally. A country's tax treatment of its private employer-based retirement plans is central to the design of its retirement income and savings program. The tax incentives associated with retirement plans generally are viewed as essential to promote the expansion of such plans. Under the U.S. model, the favorable scheme of taxation generally is reserved for so-called "qualified" plans which are governed by comprehensive rules for the most part intended to promote the policies surrounding retirement savings and income. These rules may also serve to limit the cost of these plans as tax expenditures.⁷

There are primarily three events involving a funded retirement plan that are relevant for income tax purposes: 1) contributions to a plan, 2) investment gains and losses on a plan's assets, and 3) distributions from the plan to employee participants in the plan.

Contributions. Contributions to retirement plans generally have income tax deferral as a primary tax incentive. Under this model, an employer's contributions to a plan are not currently taxable to the employee, but the employer receives a current income tax deduction for the amount of the contribution. Similarly, under defined contribution plans, employee contributions (made, for example, under a standing election by an employee to defer a portion of his or her compensation to the plan) are not included in taxable income currently, thus enabling the employee to accumulate a higher level of savings on each unit of compensation than if such savings were funded on an "after-tax" basis. As described below, most systems eventually provide for taxation of deductible employer or employee contributions (as well as earnings on contributions) when they are distributed to the employee, but the enhanced growth in retirement plan assets provided by "pre-tax" accumulation of both employer and employee contributions remains a significant incentive. Moreover, in a taxing scheme, such as that of the United States, based on a graduated rate structure, deferral of income to later, typically lower earning years, means the income generally will be taxed at lower effective rates.

Earnings. The typical model for funded retirement plans provides a second major tax incentive: investment returns are tax deferred. The funding vehicle underlying the plan is exempted from the income tax. Like contributions, the increases in

⁷Examples of these rules, which may be imposed for tax "qualification" purposes but which have no particular tax impact of their own, are minimum participation rules (rules limiting the extent to which employees may be excluded for not satisfying minimum age or period of service standards), minimum coverage rules (rules requiring that the plan cover a prescribed minimum portion of the employer's workforce), and nondiscrimination rules (rules limiting the extent to which plan benefits and other features favor more highly compensated employees).

an employee's account attributable to earnings are taxed only when distributed to the employee. As a result, the enhanced real investment return the funding vehicle enjoys, again, accelerates accumulations for secure retirement savings and income. As discussed below, the tax exemption of investment income, for private as well as government-funded plans, implies that taxation at source of investment income arising in foreign countries constitutes a disincentive for international investment of retirement plan assets.

Distributions. As noted above, benefits from funded retirement plans are typically taxable to the recipient employee when distributed. Under the typical model for defined contribution plans, distributions are taxed only to the extent the distribution exceeds contributions that have already been taxed (if, for example, as some plans or systems may provide, employee "after-tax" contributions are permitted). Under some systems, a more favorable rate, or complete exemption, on plan distributions is applied.

Government Plans. The taxation of contributions to, and distributions from, government plans may vary from country to country. Since governments do not tax themselves, however, investment income of a government fund generally is not subject to tax.

INTERNATIONAL INVESTMENT OF RETIREMENT PLAN ASSETS

International Investment of Retirement Plan Assets and Investment Restrictions. Effective investment of retirement plan assets is essential to the success of the policy of promoting retirement savings and income. This is most manifest in defined contribution plans, where the ultimate benefit is account based and depends directly on

the plan's investment performance. However, this also is true under defined benefit plans to the extent that the ability of a plan to deliver on its promised benefit depends on the security and adequacy of the underlying fund. Moreover, the ability of retirement plans to realize competitive investment returns is itself an incentive for private employers to establish and fund retirement plans, since employers perceive they may provide enhanced compensatory benefits with more limited cash commitments. The highest level of returns consistent with protecting the security of retirement assets is thus to be desired for a successful retirement system. Accordingly, and as investment markets have matured, there has been growing recognition that investment restrictions historically imposed on retirement assets should be eased. More speculative, but higher yielding, investments might be permitted as part of a diversified portfolio that, on the whole, is prudently invested and consistent with the risk and return profile associated with the plan population or the individual whose account is invested. The easing of investment limitations also permits greater diversification into more categories of investments to hedge against investment risk.

While historically many countries have placed limitations on the ability of retirement plans to invest in foreign markets, these restrictions are increasingly understood to be anachronistic. It is recognized that international investing of plan assets is actually to be favored since it can contribute importantly both to improved investment return and the protection of retirement funds through diversification, both of which are central to fostering retirement income and savings. International investing permits plans to become diversified in a way that can minimize a plan's exposure to domestic, country-specific risks, such as inflation or other economic reverses. More simply, removing the limitations on international investing permits fund managers the flexibility to pursue investments in countries offering the highest rates of return. This can be particularly important where the alternative—government imposed overconcentration of a nation's retirement plans' assets in domestic markets—can itself artificially depress marketwide returns or overheat the market as plans compete for more limited investment opportunities. While some countries may take the short-term view that a reduced cost of capital may be advantageous to the economy as a whole, the accompanying erosion in

retirement plans' assets undermines the country's own retirement policies and, significantly, deprives the global economy of what are significant sources of capital. In addition to promoting retirement policy, it is recognized to be in the interest of international economic cooperation and development that retirement plan assets be freed to be put to work in the global economy.

Source Country Taxation of Retirement Plan Investment Income. Even as the need is recognized to ease limitations on retirement plan investment in foreign assets, a significant obstacle to investment continues to exist in the form of source-country taxation of retirement plan investments. The taxing regimes of most countries do not recognize the tax-exempt status of foreign retirement plans in their home country but, instead, treat them as taxable investment entities. A retirement plan's income from foreign investments typically is subjected to source-country tax withholding in the same manner as that of a taxable investor, except that a retirement plan that is tax exempt in its country of residence (the "residence country") cannot credit withholding taxes imposed by the foreign country in which the income arises (the "source country"). Such taxation is a serious disincentive to foreign portfolio investing.

Given roughly comparable rates of tax and residence country credits for source country taxes, a taxable investor is in an essentially tax-neutral position as between domestic versus foreign investment or as among investments in various foreign jurisdictions. Retirement plans typically are not in a similarly neutral position. Untaxed on domestic investment earnings, retirement plans will favor domestic investments where nominal and real investment returns will always coincide. Although certain categories of international fixed-income investments are exempt from source-country taxation, portfolio dividends are almost always subject to withholding tax (or are denied an imputation credit) and certain gains and categories of interest are subjected to source-country taxation. International investment that is subject to source-country taxation will make sense only where domestic returns are sufficiently depressed, or foreign returns sufficiently outstanding, to make up the differential in after-tax return resulting from source-country taxation. The substantial benefits that global investing of retirement assets can offer to promote a secure system of retirement income and savings are thus seriously undermined by source-country taxation.

Retirement Plan Investment Income under Tax Treaties. Currently, only a few income tax treaties include provisions which alleviate the disincentive of source-country taxation on investment income of retirement plans.

Under the OECD Model Tax Convention on Income and Capital, there is no specific provision regarding the investment income of retirement plans. Indeed, there even is some uncertainty whether a retirement plan exempt from taxation in its country of residence would qualify as a "resident" eligible for the benefits of the OECD Model Convention. Under the Model Convention, benefits are conferred only upon "residents" of a contracting party, and a "resident" of a contracting country is defined as any person who, under the laws of that country, is "liable to tax therein." Under one reading of this provision, retirement plans would not have the benefit of the convention because of their tax-exempt status. Even if the convention applied, under the OECD Model Convention, dividend income could be subject to withholding at a rate of 15 percent and portfolio interest at a rate of 10 percent. Retirement plans would, like taxable investors, however, be free from tax on their capital gain income.

Unlike the OECD Model Convention, the U.S. Model Income Tax Convention does specifically confer "resident" status on contracting countries' retirement plans, whether or not liable to tax in their home country. However, the U.S. Model Convention imposes an additional hurdle to obtaining treaty benefits in the form of its "limitation on benefits" article. Under this article, a retirement plan will be entitled to treaty benefits only if more than 50 percent of the participants or members of the plan are residents of

that country. For most plans, this would not present much difficulty, but as employers become increasingly multinational, the limitation on benefits article could become more significant. A retirement plan having the benefit of a treaty following the U.S. Model Convention would generally be subject to 15 percent withholding on dividend income and exemption from withholding on portfolio interest and capital gain income.

A relatively few treaties, such as U.S. treaties with Canada and the Netherlands, provide for source-country exemption of certain retirement plan investment income. Only such exemption provisions fully alleviate the source-country taxation disincentive against international investment of retirement plan assets exempt from residence-country taxation.

There is an international tax policy consensus regarding the desirability of avoiding double taxation of international investment income because of the burdens taxation places on international investment flows. Bilateral income tax treaties address double taxation of taxable investors through a combination of exempting certain income or reducing source-country taxation to the point that it may be fully credited against tax imposed by the residence country. As international investment by tax-exempt retirement plan investors has grown in importance, there is an increased recognition of the desirability of eliminating the burden of source-country taxation on

retirement plan assets to facilitate free flow of this important source of international investment capital. Exemption from source taxation is the only mechanism to allow tax-neutral international investment of retirement plan assets.

A PROPOSAL FOR SOURCE-COUNTRY TAX RELIEF FOR RETIREMENT PLAN INVESTMENT INCOME

This paper proposes that retirement plan investment income be exempted on a reciprocal basis from source-country taxation. In other words, Country A would exempt from source-country taxation investment income of retirement plans resident in Country B, provided that Country B provides a reciprocal exemption for retirement plans resident in Country A. This may be accomplished by a statutory provision (that includes the reciprocity condition) or by bilateral treaty or executive agreement. If a statutory approach is adopted, a threshold issue is to identify the standard that should apply to determine when a foreign plan should be covered by the exemption rule. Under a treaty-based approach, the conditions for exemption may be negotiated on a country-by-country basis.⁸

Statutory Reciprocal Exemption. There should be three conditions for a source country to grant exemption from withholding or other taxation at source to investment income of a foreign retirement plan: 1) the foreign plan must be a retirement plan; 2) the foreign retirement plan's investment income should be exempt from an otherwise generally-applicable income tax; and 3) the residence country should provide a reciprocal tax exemption for investment income of retirement plans resident in the source country.

Definition of "Retirement Plan." Qualification of residence-country retirement plans for the exemption could be based on satisfaction of the requirements that the source country imposes on its own plans for granting exemption (the "mirror plan" approach) or on a generic

⁸Foreign government-sponsored plans' investment income may be exempt from source-country taxation in some countries under the sovereign immunity doctrine (whether the plan is part of the government's retirement security program or is a funded occupational-based plan for government employees). In such a case, it would be unnecessary to identify what constitutes an eligible pension plan or arrangement. Many "government" plans, including the retirement plans for employees of U.S. states, however, are not afforded sovereign immunity exemption. Moreover, it is not clear whether, under the bold new initiatives for government-based, privatized contribution plans, these plans would be covered by sovereign immunity. It is appropriate to identify standards for these government retirement plans as well as for private plans.

retirement plan definition. Our recommended approach to defining a retirement pension plan is to use a generic definition that limits the benefit to retirement plan assets. One such definition would be: “A trust, company, or other organization resident in [the residence country] that is generally exempt from income tax in a taxable year in that country and constituted and operated exclusively to administer or provide benefits under one or more funds or plans established and maintained to provide pension or other retirement benefits.”⁹

The “mirror plan” approach may have superficial appeal, since it permits the source country to confer exemption only in those cases which it has already deemed to be proper based on its own conceptions of protecting retirement income and savings. However, requiring a retirement plan to satisfy the conditions of myriad source-country statutory schemes in order to obtain international tax exemption would be very difficult to implement and would eviscerate the advantages of the proposal. The “mirror plan” approach would also impose the significant administrative burden of requiring a source-country competent authority to determine that the plan, in fact, meets the source country’s requirements for exemption.

Residence-Country Tax Exemption for the Foreign Plan and Reciprocal Exemption. The proposed requirement of residence-country exemption from an otherwise generally applicable income tax assures the source country that its exemption benefits the plan beneficiaries and not the residence-country tax authority while still being simple to administer. The reason for the proposed condition of reciprocal source-country tax exemption is the understandable reluctance on the part of most countries to unilaterally exempt foreign retirement plans from source-country taxation because of the consequences for government revenues and negative political perceptions.

Reciprocity is the cornerstone of a statutory approach. Such an approach is to be favored principally because of the speed with which it may be implemented, relative to amendment of extensive networks of bilateral income tax treaties.

Treaty-based Exemption. There will be circumstances where the above-described statutory approach may not be feasible. In at least one OECD country, retirement investment plan income is subject to full income taxation. In other countries there may be an absence of a generally applicable income tax. Some countries may be reluctant to adopt a statutory proposal. Each of these situations may be addressed under a bilateral agreement. This paper recommends that provisions be adopted for the OECD Model that are consistent with the principles of the proposal described above.

Benefit to Source Country. Granting reciprocal exemption from source-country taxation of retirement plan income will have economic effects within the source country. For example, tax exemption, of course, means foregone income tax collection. It is important, however, that the extent of this not be overstated. Likely, no more than a minimal amount of the income otherwise available for taxation under such a scheme could accurately be described as having been “foregone”; certainly a portion of this income will be new to the system, as the result of investment spurred by the exemption. The more significant—and favorable—effects of the exemption would be additional foreign investment in the source country’s economy as well as exemption for investment income of plans resident in the source country.

⁹The quoted definition is derived from Article XXI(2)(a) of the U.S. - Canada Income Tax Convention, but that provision also covers plans that provide “other employee benefits,” such as health and welfare plans. This paper would not recommend covering health and welfare plans under the proposal because there does not yet exist sufficient international consensus regarding the need for and manner of funding such plans, whereas such a consensus is developing with respect to retirement plans.

CONCLUSION

The worldwide aging crisis and its inexorable pressure to adopt funded retirement savings systems highlights the desirability of eliminating taxation barriers to international investment of retirement funds. Taxation at source operates as a significant barrier to international investment by retirement plans that are not taxed on income from domestic investment. This paper presents for the OECD's consideration a specific proposal to address this issue. The proposal is to encourage all member countries to adopt, by statute or bilateral agreement, reciprocal exemption from source-country taxation of investment income earned by a retirement plan that is exempt from taxation in its residence country if that country also exempts from source-country taxation income of such plans resident in the first country. The Investment Company Institute would be pleased to work with all interested persons to address the issues raised in this paper and to further develop this proposal.

APPENDIX

Features of Funded Retirement Plans

Generally. Retirement plans are typically divided into two major categories: "defined benefit" plans and "defined contribution" plans. Defined benefit plans are generally thought of as the classic "pension" plans, under which a benefit, determined by formula, is paid periodically, generally for the balance of a retiree's lifetime. Under a defined contribution model, a retiree's benefits are based, not on an established formula, but on the amount of contributions made

to the plan for the retiree's benefit during his or her working years, adjusted for investment gains or losses until actually paid.

Government-Sponsored Defined Benefit Plans. Most government-sponsored retirement security plans are defined benefit plans. How the benefit is defined may vary significantly from system to system and take into account numerous factors. The plan design will vary depending upon the extent to which the system's general goal is to provide some level of income replacement during retirement or whether it is aimed more at providing a minimum level of insurance against poverty. In pay-as-you-go plans, these benefits are financed currently out of a country's budget. Under a funded defined benefit scheme, the government's future benefits obligations are projected, based on actuarial and economic assumptions, and assets are segregated in a trust fund, or similar arrangement or account, to fund future benefits.¹⁰ The types of assets in which this fund may be invested may be limited by statute, and such funds are frequently invested predominantly in a government's own obligations. This last fact raises some question as to whether the plan is truly funded (since the security of the fund still depends on the government's solvency).

Government-Sponsored Defined Contribution Plans.

Government-sponsored defined contribution plans are currently much less common than defined benefit plans. Under such a plan, a payroll tax would essentially be replaced by a scheme of government-mandated contributions under which a percentage of a worker's earnings (or, less likely, a fixed amount) is paid into a fund and credited to an individual account maintained for the worker's benefit. The fund is invested and the individual worker's account adjusted based on the investment performance of the fund. The fund may be invested by the government itself (again, likely to be predominantly invested in its own government securities), with an individual's account determined by the investment performance of the fund as a whole, or workers may be given the ability to direct the investment of their own individual accounts among some menu of investments. The latter approach amounts to a degree of privatization of what remains, at heart, a government plan. A government-mandated contribution scheme under

¹⁰Many existing government-sponsored defined benefit plans are partially pay-as-you-go and partially funded.

which workers direct the investment of their own accounts was first adopted on a large scale in Chile and is now being introduced in a number of other countries worldwide.

Private Plans Generally. Private employer-based plans fall into the same two general categories of defined benefit and defined contribution plans, but have a number of notable differences. For both types of plans, the worker's benefit under an employer's plan generally depends on the worker's service history with the employer. The ultimate benefit will be based, in some fashion, on his or her earnings history and length of service with the specific employer. Under a private scheme, a worker's benefits are "career" benefits like those of a public pension scheme, but in this era of mobile labor markets and high worker turnover, the "career" benefit may be the product of a number of separate employers' plans. This is significant because, for the most part, OECD countries do not require employers to adopt their own plans or impose standards for minimum benefits. A worker's retirement income under a private system will depend on the existence and generosity of his or her former employers' plans, which, in turn, will likely depend on the success of the government's policy to induce employers, through incentives, to adopt retirement plans.

Private Defined Benefit Plans. In a private, employer-based defined benefit plan, the benefit formula is almost universally a direct function of the employee's earnings history and length of service, aimed at providing income replacement during the retirement years. Typically, the benefit, expressed in terms of an annuity, provides a fraction of the employee's final average or career average pay, tied to the employees' length of service with the employer. Thus, a worker passing through a number of employers, and a number of employers' defined benefit plans, may in the course of a career collect a number of pensions representing different portions of his or her career earning history. (There almost always is a *de facto* penalty in the form of reduced benefit levels for changing employers.) Like governments funding similar benefit retirement security arrangements, employers maintaining private defined benefit plans must project their future benefits obligations and make contributions or set aside reserves based on these projections. Contributions segregated from

the employer's general assets in a trust or similar vehicle may be invested with the goal of having sufficient assets in the fund to support the anticipated benefit obligations. Clearly, the insulation of the employer's contributions from the claims of creditors adds to the security of the pension promise. Reliance on professional investment managers to manage these funds further enhances the likelihood that funds will be preserved to meet pension obligations.

Private Defined Contribution Plans. In private, employer-based defined contribution plans, the source of the contributions providing the base for the worker's benefit may be employer-based, worker-based, or a combination. Employers may, for example, commit to providing annual (or other periodic) contributions to a retirement plan based on a percentage of each worker's compensation or may make discretionary contributions from year to year. Many plans may be funded, either in whole or in combination with employer contributions, by employee contributions of a portion of their current income. Employee funding may be entirely voluntary or may be government- or employer-mandated. Once contributed to the fund—again, typically a separate trust or similar arrangement—and credited to individual workers' accounts, the contributions are invested, with the workers' individual account balances being the ultimate measure of their benefits. Again, the fund may be managed, in whole or in part, by the employer or professional investment advisor retained by the employer, or employees may be given the ability to direct the investment of their own accounts.

Employers adopting retirement plans, at least in the United States, increasingly favor defined

contribution plans over defined benefit plans. The classic defined benefit pension evolved when lifetime employment with a single employer was the model for most workers, and the lifetime pension was an almost paternalistic extension of this relationship by the employer. Now, with this model becoming by far the exception rather than the rule, defined benefit plans hold less attraction since they generally provide little in the way of meaningful pension benefits to shorter service employees and, as described above, a worker's career pension benefit may become a patchwork of

pensions from a variety of employers. The nature of a defined contribution benefit, based on an account balance that directly represents a share of plan assets, makes such benefits extremely portable, permitting them to be carried (or "rolled over") from one employer's plan to another. An employer may provide more meaningful benefits to shorter service employees, and this portability permits an employee's retirement benefit to eventually reside in a single plan, increasing the efficiency of the delivery of such benefits. Defined contribution plans also permit employers to shift to workers some of the responsibility for their own retirement income through employee-funded contributions to the plans without decreasing compensation levels.

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