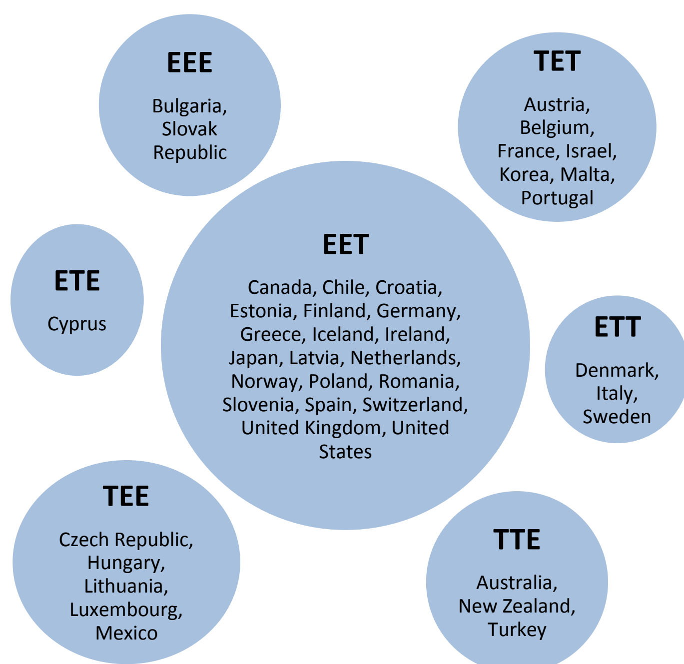
Tax treatment of retirement savings in private pension plans across OECD countries

Countries encourage saving for retirement by taxing retirement savings in private pension plans differently than savings in alternative vehicles or offering other financial incentives.

Figure 1. Tax treatment of retirement savings in private pension plans



Note: Main pension plan in each country.
Source: OECD (2015), Stocktaking of the tax treatment of funded private pension plans in OECD and EU countries.

About half of OECD and EU countries apply a variant of the “Exempt-Exempt-Taxed” ("EET") regime to retirement savings, where both contributions and returns on investment are exempted from taxation while benefits are treated as taxable income upon withdrawal. Other tax regimes can also be found, from the “Exempt-Exempt-Exempt” ("EEE") regime where contributions, returns on investment and pension income are all tax-exempt, to regimes where two out of three flows of income are taxed (Figure 1). In contrast, the "TTE" tax regime usually applies to savings in other vehicles.

Figure 1 hides the heterogeneity that exist within countries regarding the tax treatment of contributions, returns on investment and withdrawals. Indeed, the tax treatment of contributions to private pension plans may change according to the source of the contribution (the employee or the employer), their mandatory or voluntary nature, and the type of plan in which they are paid (personal or occupational plans). In many countries, people not paying income taxes do not get any relief on their contributions into private pension plans.

Most countries exempt from taxation returns on investment in private pension plans. When returns are taxed, tax rates may vary according to the duration of the investments (e.g. Australia), the type of asset classes (e.g. Italy), or the income of the plan member (e.g. New Zealand).

The tax treatment of pension income is usually identical across different types of pay-out options (life annuity, programmed withdrawal or lump sum). Only the Czech Republic and Estonia incentivise people to annuitize their pension income through a more favourable tax treatment for annuities as compared to programmed withdrawals. Conversely, lump sums are tax-free up to a certain amount or only partially taxed in many countries in order to reach a more neutral tax treatment across the different pay-out options.

The complexity of the tax system may have led some countries to introduce more direct financial incentives to encourage participation and contributions to the private pension system, especially for low-income people. These include tax credits (e.g. the United States), matching contributions from the state (e.g. Australia) or from the employer (e.g. Iceland and the United States) and state flat-rate subsidies (e.g. Germany). These incentives are provided to eligible individuals who actually participate or make voluntary contributions to the private pension system.

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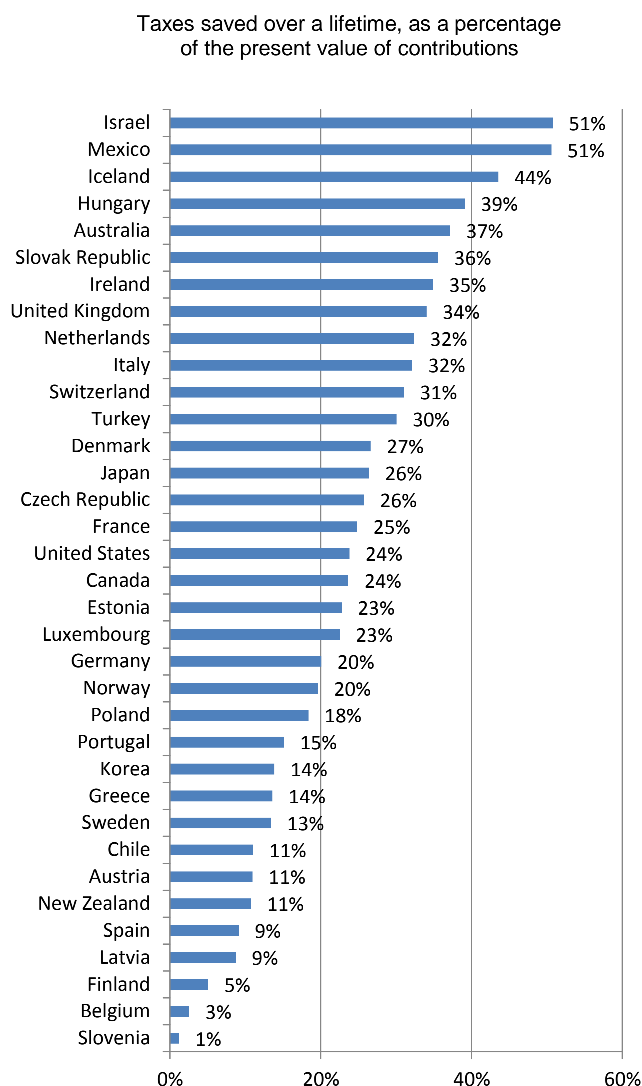
The different tax treatment between private pension plans and other savings vehicles translates into a pecuniary advantage when people save for retirement in private pensions. In most cases, individuals save in taxes paid by contributing the same pre-tax amount to a private pension plan instead of to a benchmark savings vehicle. This tax advantage derives from the fact that the preferential tax treatment that contributions and returns on investment usually enjoy in a private pension plan outweighs the potential taxation of benefits.

Across the OECD, average earners can expect to save in taxes paid over their lifetime by contributing to a private pension plan rather than to a traditional savings account (Figure 2). This amount varies from 1% of the present value of all contributions in Slovenia, up to 51% in Israel and Mexico. Some of the largest private pension markets, like Canada, Denmark, the Netherlands, Switzerland, the United Kingdom and the United States, provide tax advantages between 24% and 34%, with Canada and the United States at the bottom of that range and the Netherlands and the United Kingdom at the top. The calculations assumes that the average earner enters the labour market at age 20 in 2015 and contributes yearly until the country's official age of retirement at a rate equal to the minimum or mandatory contribution rate fixed by regulation in each country or 10% of wages in the case of voluntary plans. The total amount of assets accumulated at retirement is converted into an annuity certain with fixed nominal payments. Inflation is set at 2% annually, productivity growth at 1.5%, the real rate of return on investment at 3% and the real discount rate at 3%.

The differences observed across countries are due not only to the characteristics of the tax regimes applied to pension plans and savings vehicles, but also to the characteristics of the personal income tax system in each country (i.e. the tax brackets and the tax rates). In Greece and Canada for example, the lifetime tax advantage of contributing to a private pension plan is different (24% and 14% of the present value of contributions respectively), even though an "EET" tax regime applies to pension plans in both countries. However, an average earner in Canada has a 31.15% marginal tax rate, while an average earner in Greece has a 22% marginal tax rate.

Figure 2. Generosity of the tax treatment of retirement savings in OECD private pension plans



Note: Average earner, main pension plan in each country.
Source: OECD Pensions Outlook 2016, Chapter 2.