Alternative approaches to designing financial incentives

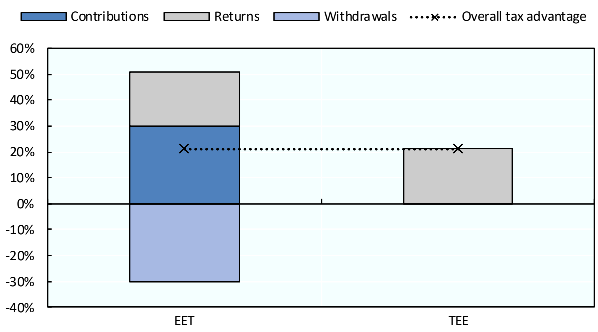
The most common type of financial incentive used by governments to promote savings for retirement, is to defer taxation by taxing individuals only on their pension benefits ("EET"). Governments are alternatively using other approaches to providing financial incentives, either through the tax system (e.g. upfront taxation or tax credits) or outside the tax system (e.g. matching contributions and fixed nominal subsidies).

Taxing retirement savings upfront or upon withdrawal

Taxing retirement savings upfront (i.e. taxing only contributions, "TEE") is often seen as an equivalent approach to taxing retirement savings upon withdrawal ("EET"). Both tax regimes do indeed provide the same overall tax advantage to individuals when their income is subject to the same marginal tax rate throughout working and retirement years (Figure 1).

Figure 1. Overall tax advantage for the "EET" and "TEE" tax regimes

Present value of taxes saved over a lifetime, as a percentage of the present value of contributions

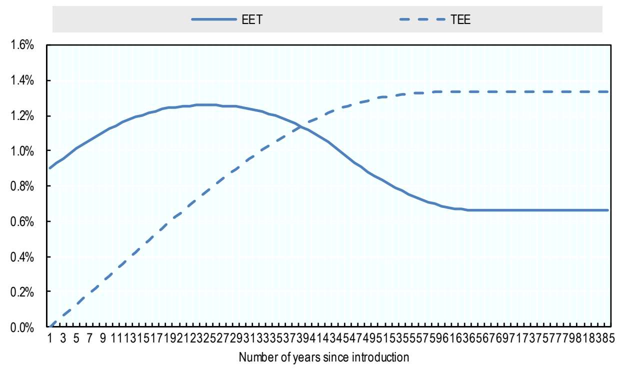


In reality, however, individuals rarely face the same tax rate over their entire life, so taxing retirement savings upfront or upon withdrawal is seldom equivalent. As individuals usually experience a fall in their income upon retirement, their retirement income is likely to be taxed at a lower overall rate than their work income. In that case, individuals would be better-off if their savings are taxed upon withdrawal. In contrast, individuals would be better-off paying taxes upfront when they expect tax rates during retirement will be greater than when they are working.

In the long run, upfront taxation may translate into a higher fiscal cost than taxation upon withdrawal. Figure 2 compares the yearly fiscal effects of the two tax regimes. It shows that, in the short term, upfront taxation leads to a lower fiscal cost than taxation upon withdrawal. Taxing only withdrawals and thus deferring tax collection, brings the full cost of tax revenues forgone on contributions upfront. With upfront taxation, the fiscal cost is just equal to tax revenues forgone on returns. In the long term, once the two systems reach maturity, the fiscal impact is reversed with taxation upon withdrawal leading to a lower annual fiscal cost than upfront taxation. This is because the tax revenues collected on withdrawals more than compensate for tax revenues forgone on contributions as the size of withdrawals in a given year exceeds the size of contributions in a mature pension system.

Figure 2. Net tax expenditure for maturing "EET" and "TEE" tax regimes

As a percentage of GDP



Using tax credits or tax deductions

For individuals, there is no difference between a tax credit and a tax deduction in terms of taxes saved when the credit rate is equal to their marginal income tax rate.

Tax credits lead to lower differences in the overall tax advantage across different income groups than tax deductions at the marginal rate. This stems from tax credits providing the same tax relief on after-tax contributions to all individuals independently of their income level and marginal income tax rate. Tax deductions can lead to the same outcome across income groups when the deduction is provided at a single fixed rate.

Non-refundable tax credits and tax deductions are of no value to individuals with low or no income tax liability, while refundable tax credits do. Individuals whose tax liability is lower than the value of the tax credit, will not receive the full credit when it is not refundable. For individuals not paying income tax, deducting contributions paid into a pension plan has no effect on their income tax, as none is due. To restore the attractiveness of tax credits for low-income earners, the treasury could pay individuals the difference between the value of the tax credit and an individual's tax liability when positive, therefore making the tax credit refundable.

Using tax incentives or non-tax incentives

Non-tax incentives are attractive to all individuals as they are not linked to an individual's tax status. Matching contributions are calculated as a proportion of after-tax contributions. With fixed nominal subsidies, all eligible individuals receive the same amount in their pension accounts. As the value of non-tax incentives is not limited by the tax liability, all individuals can fully benefit from them, as long as they fulfil the entitlement requirements.

Non-tax incentives are always paid directly into pension accounts, which may not always be the case with tax incentives. Individuals eligible for a tax credit or a tax deduction may not save the value of the incentive in their pension accounts. When contributions are first taxed at an individual's marginal rate and the tax refund is provided later in the year or the following year, individuals need to anticipate that they will eventually get a tax refund and increase their after-tax contribution to save the whole tax relief in the pension account.

Matching contributions may also have a larger impact on retirement savings than economically equivalent tax credits. A credit rate of t is economically equivalent to a match rate on the contribution of t/(1-t). For example, a 33% refundable tax credit is economically equivalent to a matching contribution of 50%. However, individuals may not perceive the two designs as economically identical. Some individuals may perceive a 33% credit rate as equivalent to a 33% match rate, thereby reducing the incentive of the tax credit.

Matching contributions alone, when not associated with other tax incentives, provide a higher overall tax advantage to low-income earners in progressive tax systems. This is despite the fact that the match rate is equal for everyone. When the matching contribution is associated with a "TTE" tax regime, the match rate applies to after-tax contributions, implying that individuals with higher marginal tax rates receive a lower tax advantage on their contributions. Moreover, returns on investment are taxable. Taxes paid on returns are higher compared to a traditional savings vehicle because matching contributions increase the level of total contributions and generate additional investment income. Therefore, the overall tax advantage provided by matching contributions declines with the individual's income level.

Most OECD countries already have tax incentives in place. Removing them may be politically delicate and cumbersome in practice. Adding non-tax incentives to existing tax incentives is an option. Introducing matching contributions for a pension plan that is already subject to the "EET" tax regime increases the overall tax advantage provided to individuals and the fiscal cost to the treasury, but achieves a smoother overall tax advantage across income groups. Any additional fiscal cost is limited in the long term by the extra tax collected on larger withdrawals.