

Long-term fiscal cost of tax incentives for private pension plans

Promoting private pension provision via tax incentives represents a cost for the Treasury, or tax expenditure, in terms of revenues forgone from personal income tax. In many countries, retirement savings in private pension plans are subject to the “Exempt-Exempt-Taxed” (“EET”) regime, where both contributions and returns on investment are exempted from taxation while benefits are treated as taxable income upon withdrawal. This deviates from the tax treatment that usually applies to savings in other vehicles (“TTE”) and produces a tax expenditure stemming from the tax deferral and the exemption of returns on investment.

Several OECD countries produce their own tax expenditure reports. These national reports provide an assessment of the cost of granting tax incentives to promote private pensions. Unfortunately, they do not allow for cross-country comparisons as the items reported as tax expenditures vary by country. For example, some countries include the tax collected on pension withdrawals and consider it as a negative tax expenditure, while other countries only report revenues forgone.

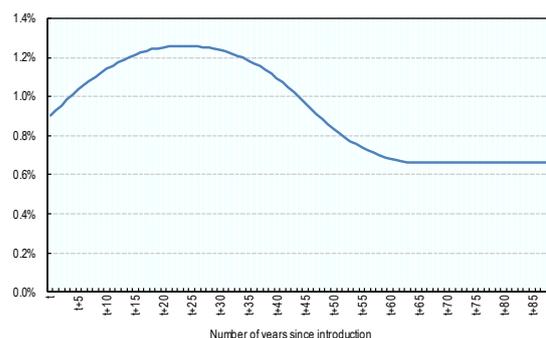
To compare the cost related to tax incentives for private pension plans across countries and assess its evolution over time, taking into account demographic trends, the OECD has calculated a net tax expenditure indicator using a homogenous approach. This indicator sums up how much personal income tax is collected or forgone each year over the total population on contributions, returns on investment and withdrawals, as compared to a “TTE” benchmark.

Introducing a pension system with an “EET” tax treatment for retirement savings creates a larger upfront net tax expenditure. It is only several decades later that the new pension system and its tax expenditure reach a steady state. Figure 1 illustrates an “EET” pension system introduced

in year t , with contributions starting in that same year. The system matures over time as it takes time for retirees to draw their pension based on a full career.¹ The net tax expenditure first rises before declining and reaching its steady-state level. During the maturing phase, aggregated asset and benefit levels increase over time until they reach a stable level. The lag in the growth of benefits behind that of assets and investment income is what creates the temporary increase in the net tax expenditure above its steady-state level.

Figure 1. Net tax expenditure for a maturing “EET” pension system

As a percentage of GDP

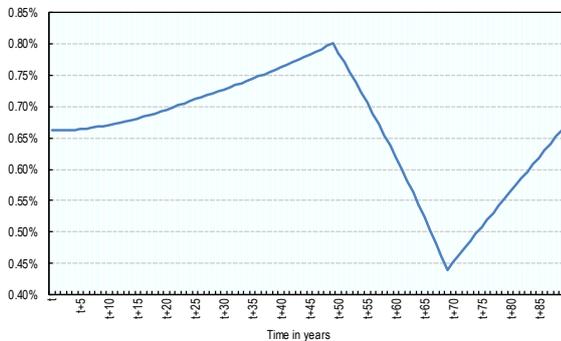


The net tax expenditure is also impacted by demographic trends. Figure 2 illustrates how the net tax expenditure varies when the size of the cohorts entering the labour market between $t+5$ and $t+24$ is larger. Larger cohorts entering the labour market translates into higher contributions and higher assets, bringing the net tax expenditure above the steady state for a while. When the larger cohorts retire, the net tax expenditure declines and reaches a minimum (below the steady state) the year in which all of the retired population is composed of individuals in the larger cohorts. The steady state is reached again when all the individuals in the larger cohorts have passed away.

¹ Similarly, a change in contribution rules can also make a pension system to enter a maturing phase.

Figure 2. Net tax expenditure for an “EET” pension system with a population bulge

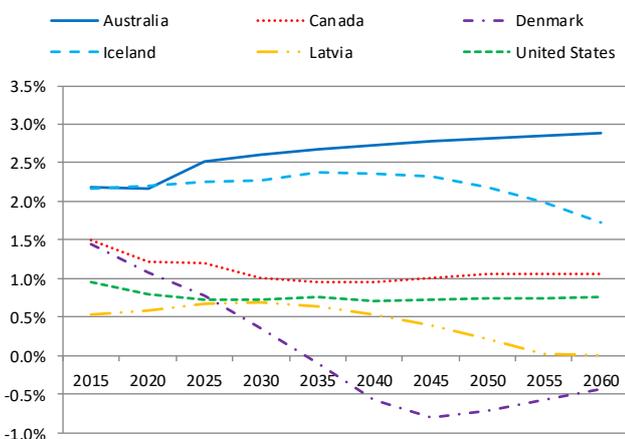
As a percentage of GDP



The net tax expenditure indicator calculated using an homogenous approach with country specific parameters shows different time profiles. These time profiles depend on the maturing status of the pension system and the countries’ population ageing (Figure 3). Most of the private pension systems reported in Figure 3 are still maturing, due to the recent introduction of the system (Latvia), changes in contribution rates (Australia, Iceland) or past changes in coverage and contribution rates (Denmark). Depending on how far back these changes have taken place, the net tax expenditure may be in an increasing trend (Australia, Iceland, Latvia) or a decreasing trend (Denmark).

Figure 3. Projected net tax expenditure related to the tax treatment of private pension plans in selected OECD countries, 2015-2060

As a percentage of GDP



Note: Calculations using the revenue forgone method and the cash flow approach.

The ageing of baby-boom cohorts is the main factor driving the decline in the net tax expenditure between 2015 and 2030-35 in Canada and the United States. As baby-boomers start retiring and withdrawing their benefits, revenues collected on pensions will increase, thus reducing the net tax expenditure. In both countries, the maturity of the private pension system is such that tax revenues collected on withdrawals is projected to exceed tax revenues forgone on contributions for the whole analysed period 2015-2060.

Taking into account corporate income tax revenues and the potential effects of new savings would reduce the cost of tax incentives. Indeed, when savings are invested in domestic equities or corporate bonds, they help companies improve their productive capacity, thereby raising the overall level of profits that are subject to corporate income tax, and thus increasing corporate income tax revenues. In addition, should tax incentives for private pension plans lead to new savings, this would impact tax revenues too. New savings are financed by a reduction in consumption and imply higher investment than otherwise. Therefore, new savings affect consumption tax revenues as well as personal and corporate income tax revenues through higher accrued income. As long as private pension plans invest part of the savings in domestic equities or corporate bonds, and/or some of the savings would not have been done in the absence of tax incentives, the fiscal cost of those tax incentives would be reduced as compared to that shown in Figure 3. The exact reduction is however difficult to estimate as it depends on assumptions on how several parameters may evolve over time.