Size and distributional pattern of pension-related tax expenditures in European countries

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- Tax expenditures are departures from a benchmark tax system (usually *preferential* tax treatments) granted to specific individuals or categories of households which aim at achieving social and economic goals
  - Presented as tax cuts rather than increases in spending: “soft policy device” (Kalyva, 2016; Stiglitz 2002)
    - instruments vulnerable to lobbying more than equivalent spending programs
    - fiscal and equity impacts not always clear
  - Subject to a lack of transparency (Tyson, 2014)
    - effectiveness and efficiency need to be carefully evaluated

- First attempt to quantify the fiscal and equity effects of pension-related tax expenditures across all European countries
  - Microsimulation approach

- The taxation of pensions can take place in three possible points in time
    - i) when part of the income is saved and contributions to the pension system are paid
    - ii) when investment income and capital gains accrue
    - iii) when pension benefits are received

The benchmark system

- The choice of the benchmark system is crucial and related to the debated principles of optimal taxation of pensions (Cremer and Pestieau, 2016)

- EET (like TEE) is equivalent to a consumption or expenditure tax
  - Deductibility of contributions and taxation of pension benefits to avoid double taxation
- EET preferred over TEE
  - If individuals are myopic and tend to under-invest for retirement
  - Pension savings more attractive than under TEE as there is always the risk that future governments will act to tax pension benefits
  - With progressive tax EET encourages earlier and greater savings because grants tax relief before retirement when marginal tax rate is higher (Armstrong et al. 2015)

- OECD (2015) taxonomy:
  - I pillar: public benefits that do not depend on the amount of contributions. Its aim is to avoid poverty in the old age and its impact is highly redistributive
  - **II pillar**: occupational, in most of the cases mandatory, either public or private, pursues the maintenance of working age living standards during retirement
  - **III pillar**: voluntary and tries to address individual preferences for retirement savings versus alternative forms of savings.

- Most countries follow an E(E)T approach but with several tax expenditures in place
  - Pension contributions (fully or partially) not exempted
    - Negative Tax Expenditure, partly compensated by lower tax on private pensions
  - Pensions (fully or partially) not taxed
    - To support elderly incomes by smoothing income over the life-cycle and prevent elderly poverty

Microsimulation approach

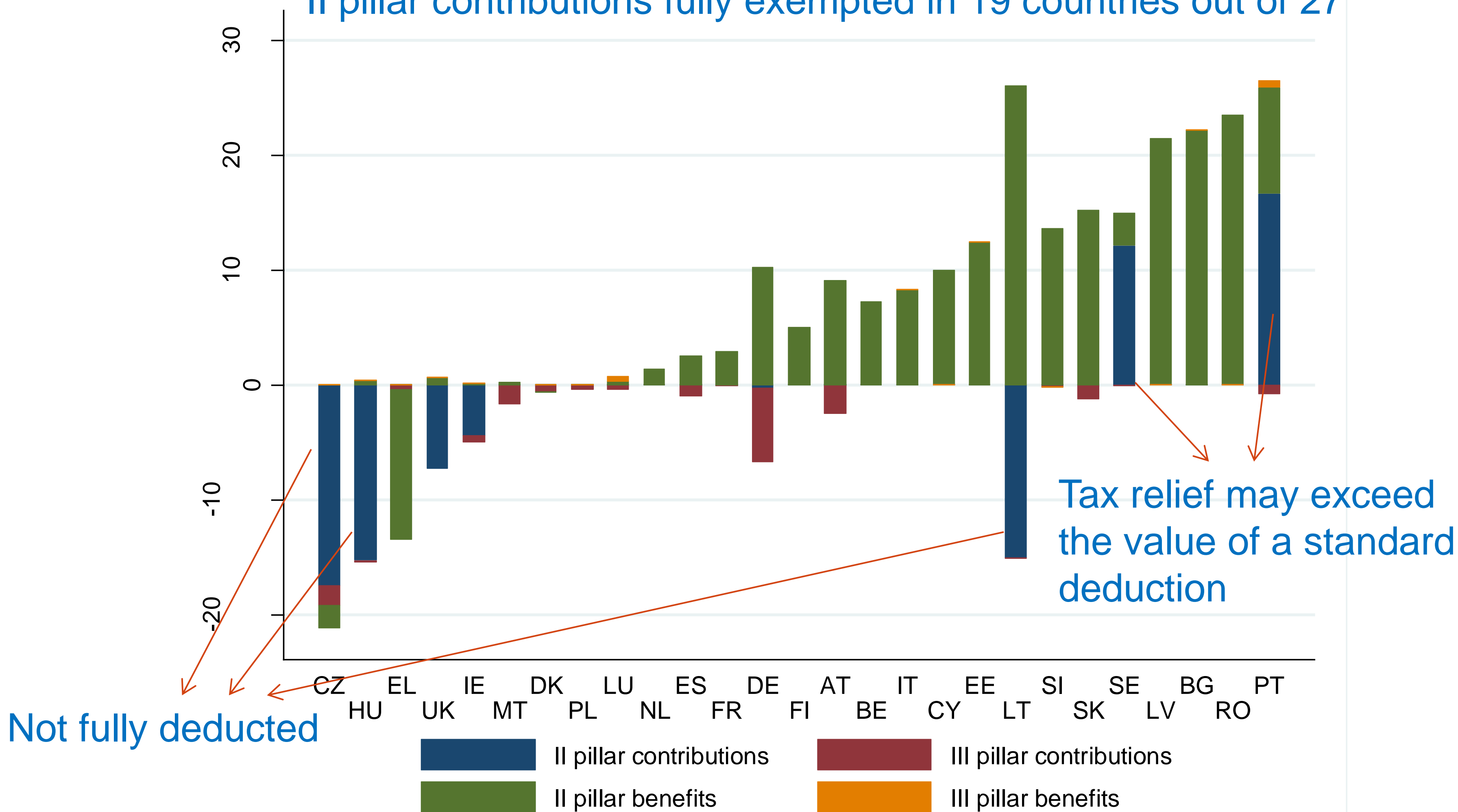
- Analysis based on a benchmark tax-benefit system scenario implemented with a microsimulation approach (Figari, Paulus and Sutherland, 2015)
  - Analysis based on the comparison between the current tax-benefit system and a benchmark scenario – E(E)T – where existing pension-related TEs are removed
    - revenue foregone approach (Revenue cost due to TEs)
    - II and III pension pillars
  - Fiscal and equity impact based on micro-data representative of the national population
  - Interaction between different tax instruments and benefit entitlements

- EUROMOD (Sutherland and Figari, 2013)
  - 2013 policy system
  - 2010 EU-SILC (+ FRS for the UK) data uprated to 2013

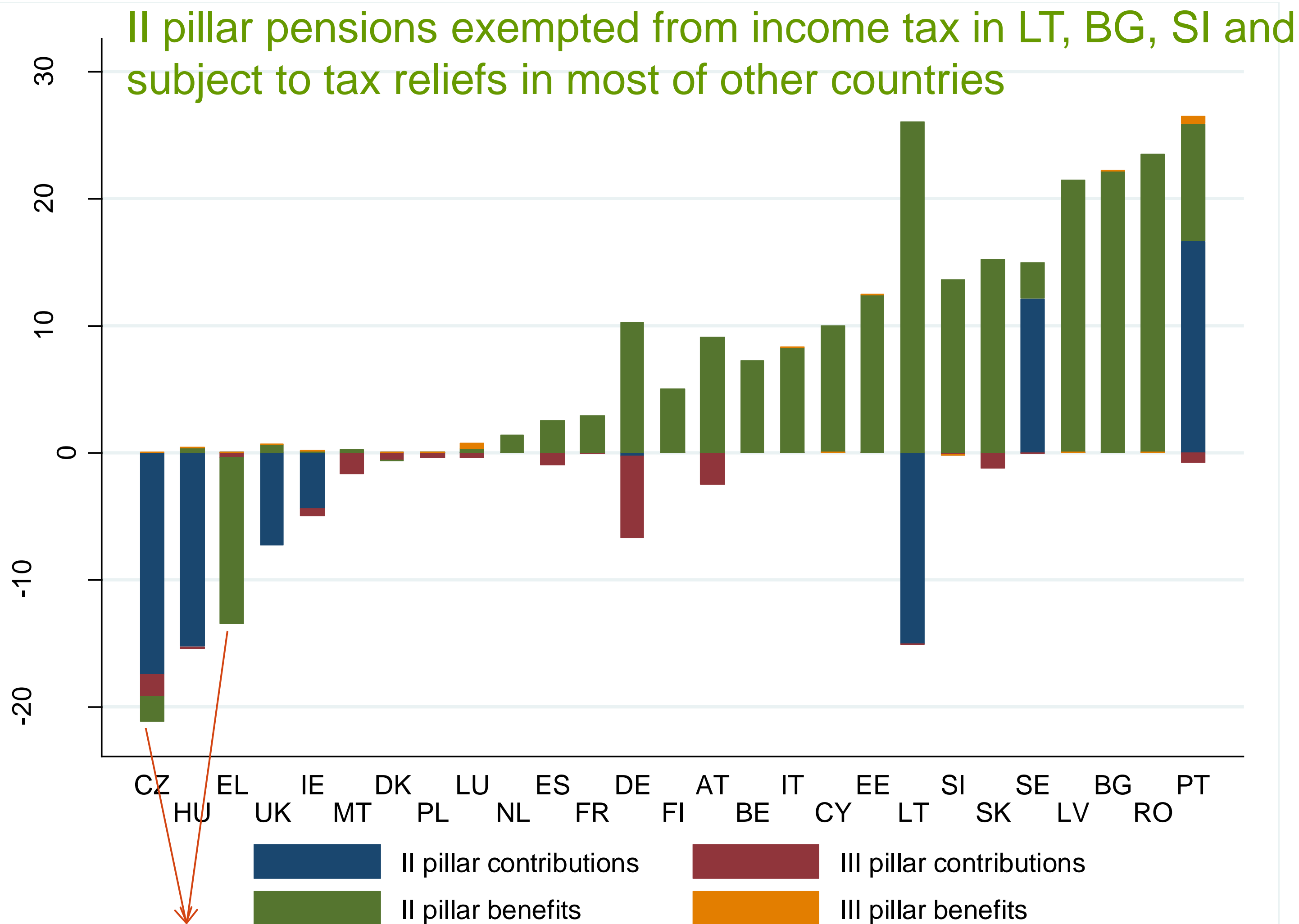
Microsimulation approach

- Static approach
  - Appropriate to highlight the effect of tax expenditures on the working population and the elderly at a given point in time
  - Does not take into account potential behavioural reactions
    - but the greatest part of the tax expenditures adopted in European countries are actually targeted to elderly people that cannot react by changing their labour supply
  - It allows to construct an age profile of tax expenditures useful to define the present value in a life cycle perspective
    - but this builds on strong assumptions about the evolution of the contribution history, of the taxation on contributions and pensions systems.

Pension-related TEs – Revenue cost

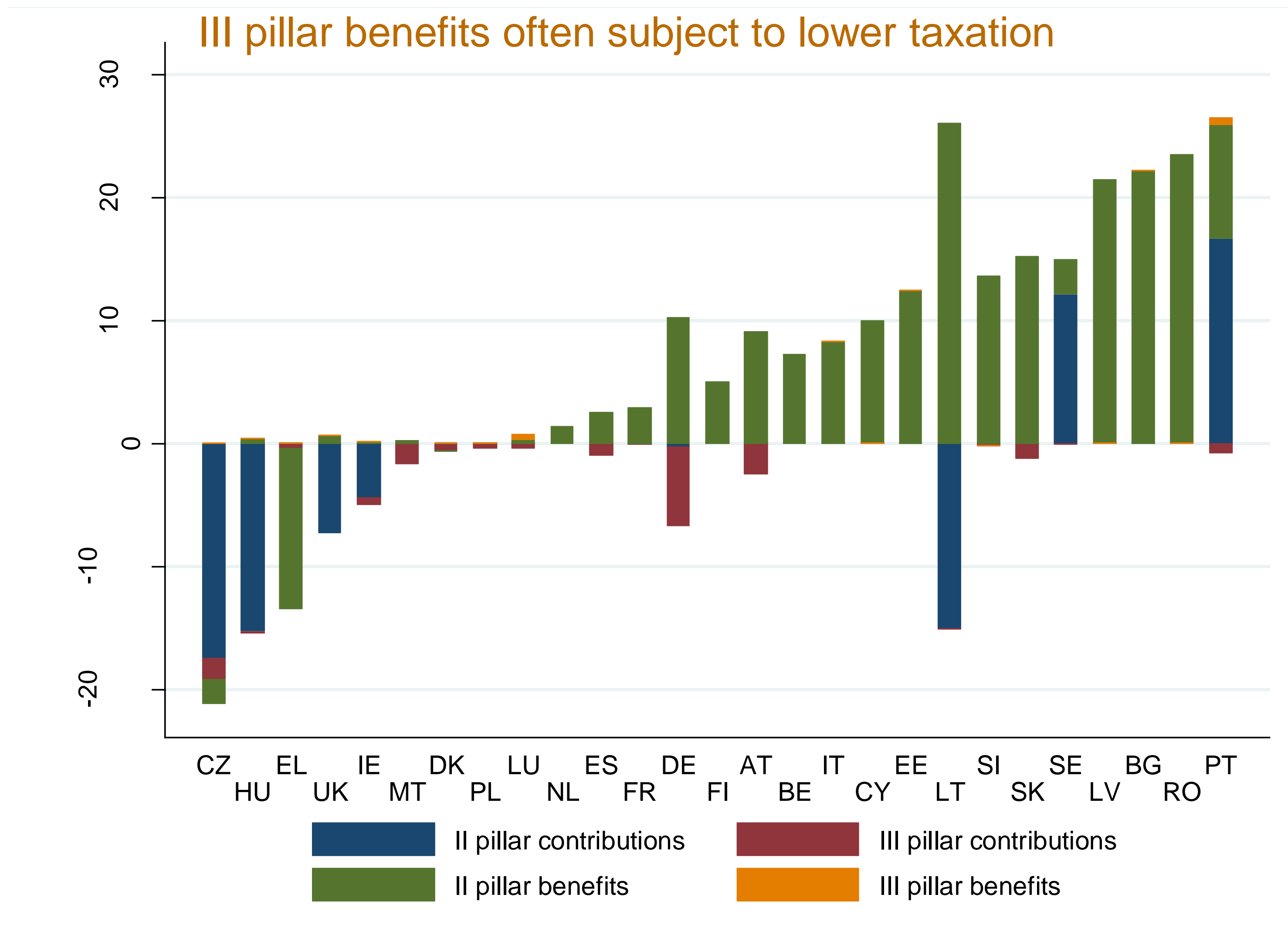


Pension-related TEs – Revenue cost



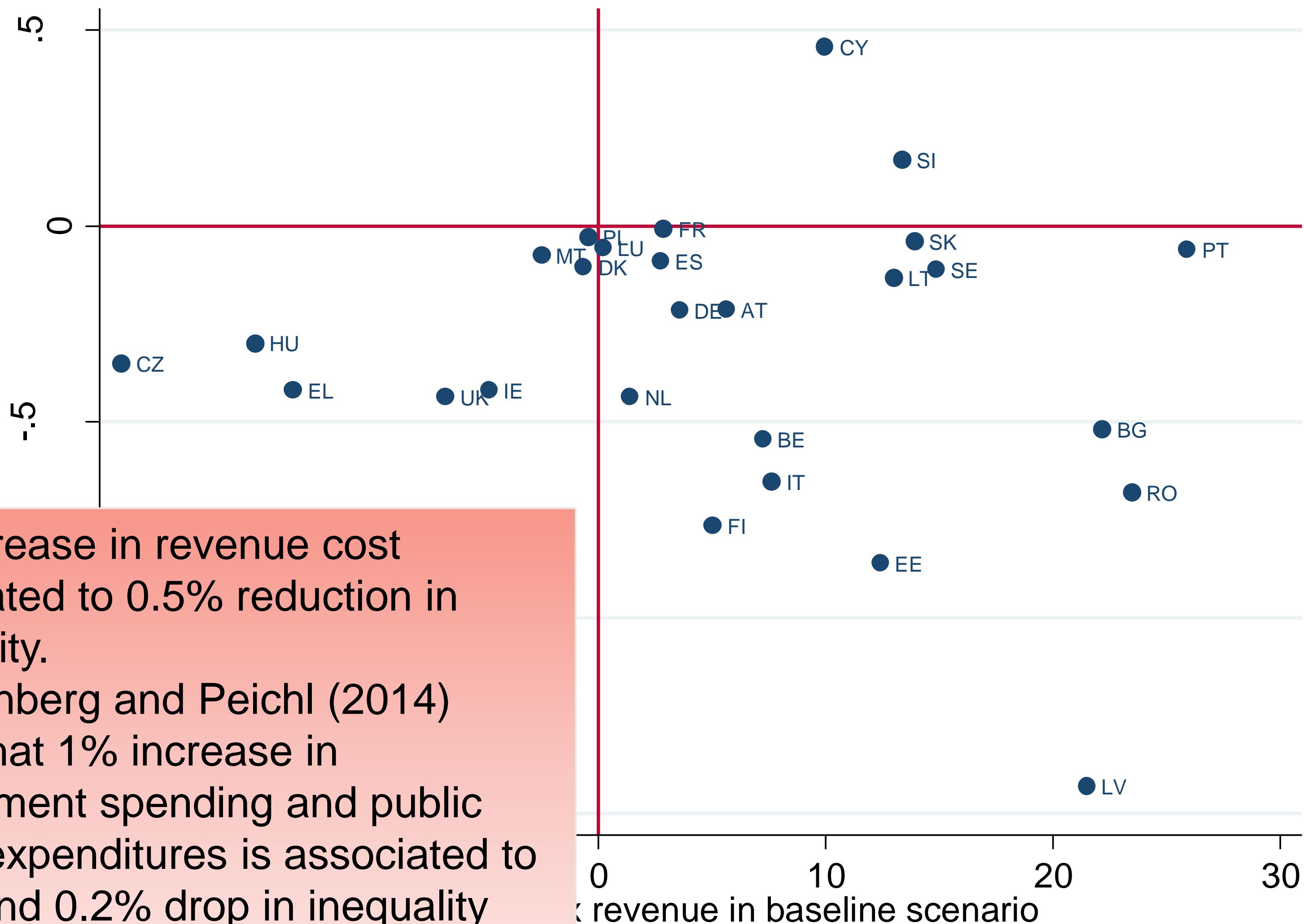
The main exceptions to this pattern are represented by Greece and Czech Republic

Pension-related TEs – Revenue cost



III pillar contributions often not fully deducted

Pension-related TEs: fiscal cost and effect on inequality



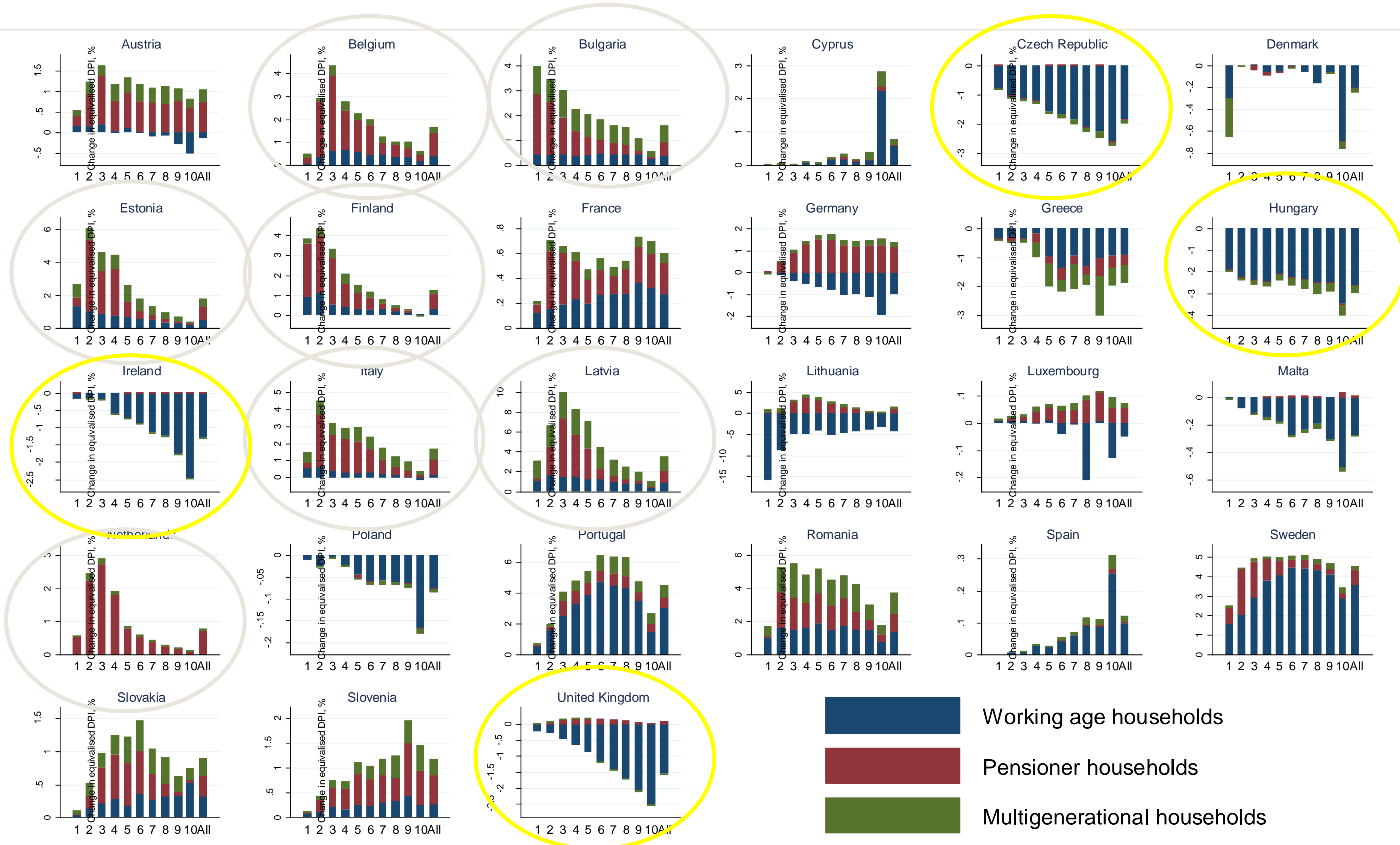
1% increase in revenue cost associated to 0.5% reduction in inequality.

Doerrenberg and Peichl (2014) show that 1% increase in government spending and public social expenditures is associated to 0.3% and 0.2% drop in inequality

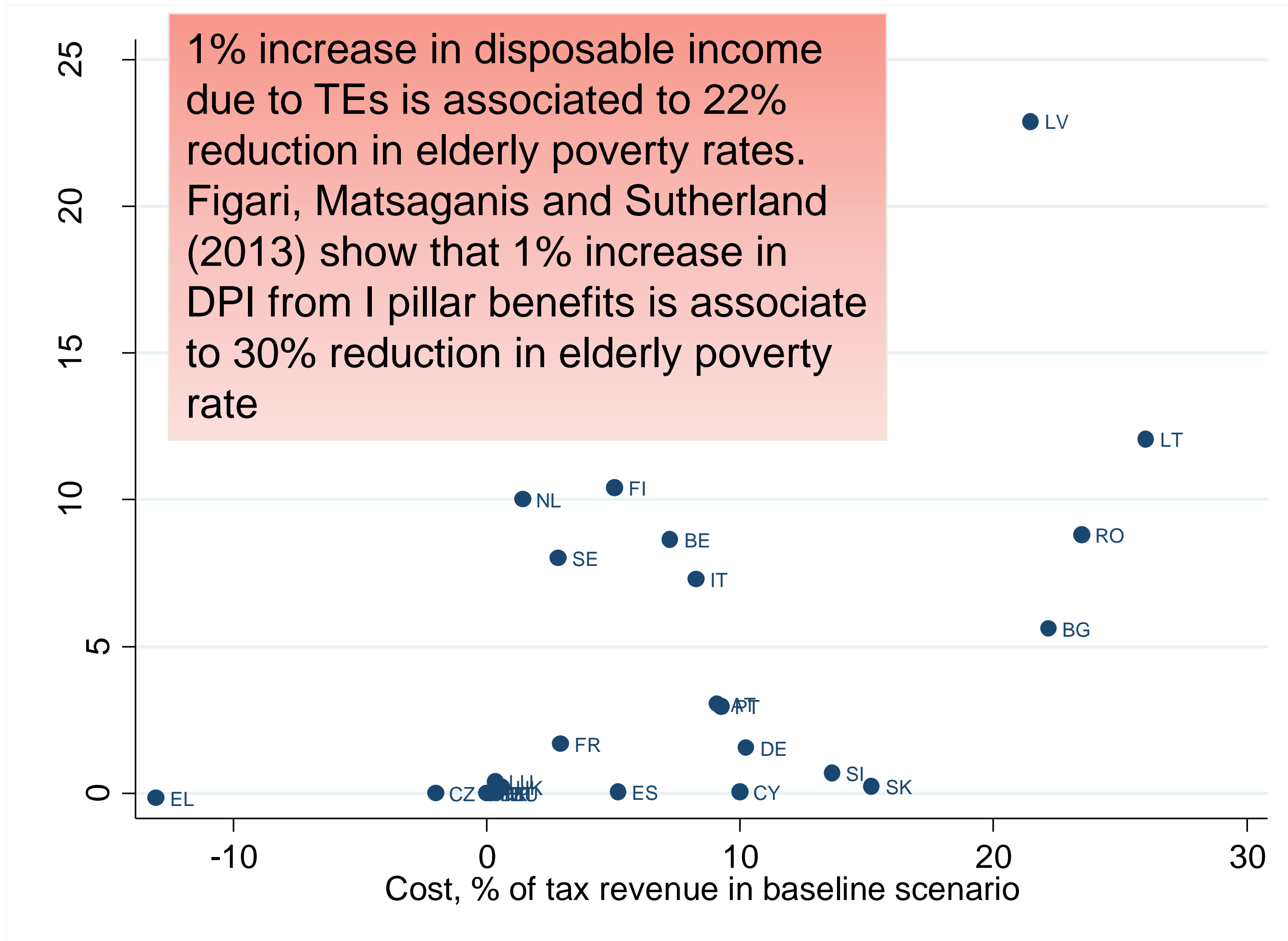
Pension-related TEs: distributional pattern by age

Austria
Belgium
Bulgaria
Cyprus
Czech Republic
Denmark
Estonia
Finland
France
Germany
Greece
Hungary
Ireland
Italy
Latvia
Lithuania
Luxembourg
Malta
Netherlands
Poland
Portugal
Romania
Spain
Sweden
Slovakia
Slovenia
United Kingdom

Pension-related TEs: distributional pattern by hh type and income



Effectiveness of pension-related TEs in addressing elderly poverty rates

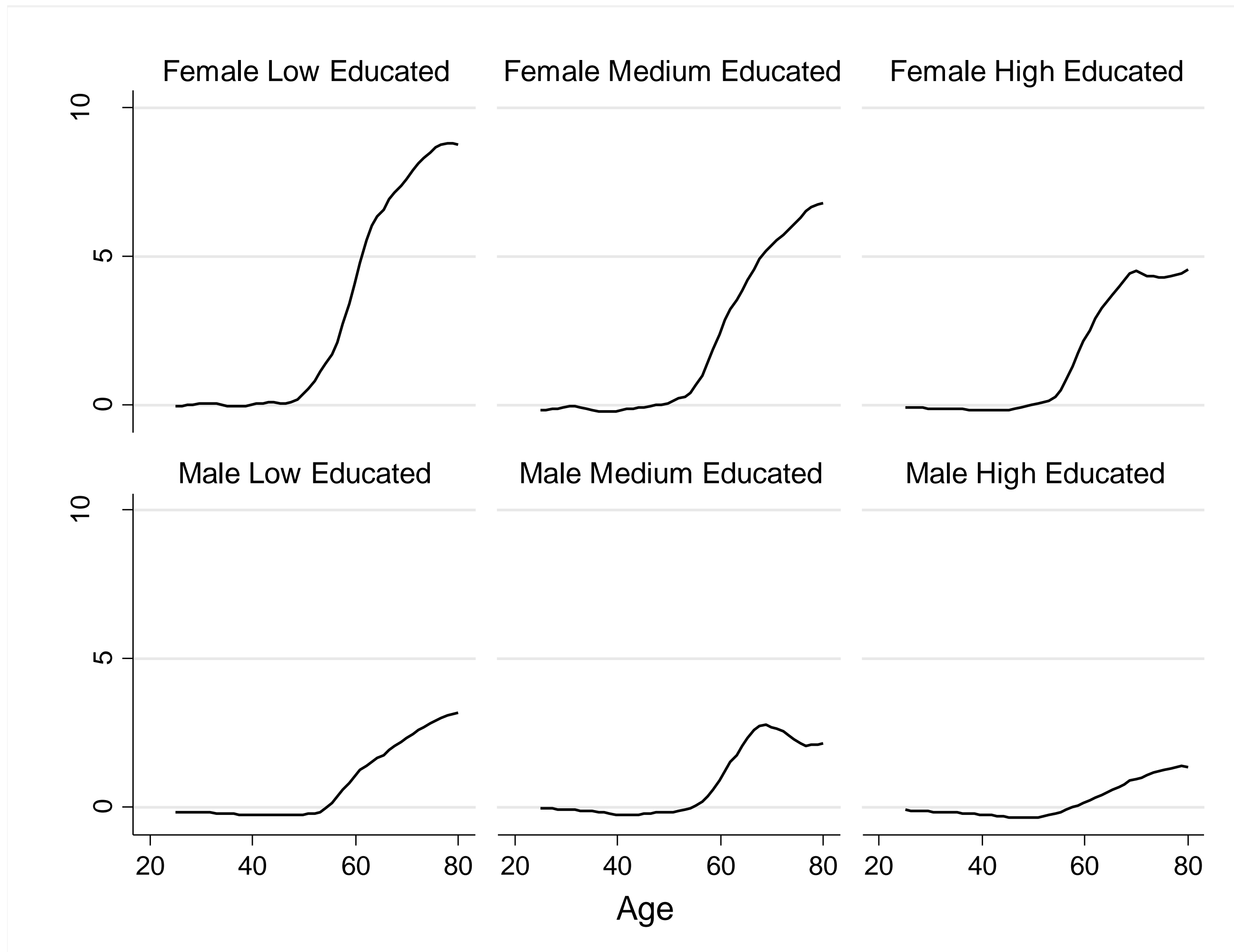


A lifetime perspetive ?

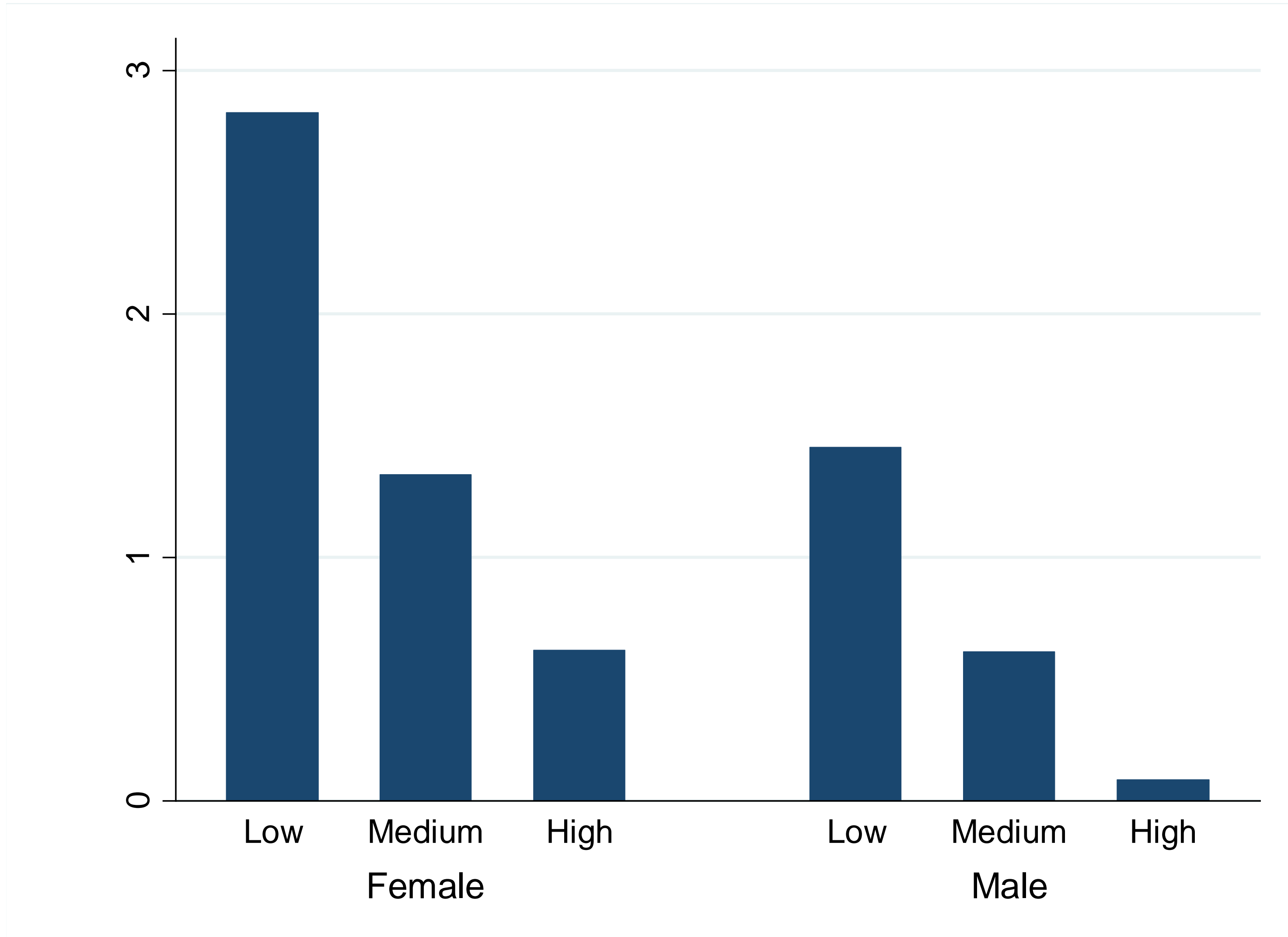
- Pension-related TEs have intra-generational implications on a lifetime basis
- How can we extend the static approach and the cross-sectional inter-generational analysis to consider a lifetime perspective?
  - With an feasible approach considering the cross-country perspective

- A first attempt related to Italy
  - Based on a generational accounting methodology (Ter Rele, 2007)
  - For an average individual aged 25 years old we can calculate the present value of the TEs over his lifetime assuming his earnings or pensions at time t+1…T are proxied by those of observed age+1…T
    - by gender and education
    - assuming r=2% and g=0.5%

Pension-related Tes by age, gender, education

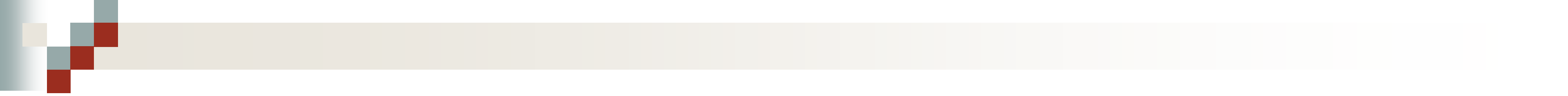


Pension-related TEs present value by gender and education



Conclusions

- Impact of pension-related TEs on tax revenues and on income inequalities can be sizeable.
  - The capacity of the pension systems to guarantee their adequacy and sustainability will also depend on their interaction with the overall tax-benefit system
- The budgetary and equity impact of the pension-related TEs is clearly differentiated across countries
  - Evaluation needed in the present context of constrained public finances
- In a cross-sectional perspective, pension-related TEs tend to be progressive at two levels:
  - first among pensioners, by favoring lower income elderly (mainly through a favorable tax treatment of pension incomes)
  - second among working-age individuals (through partial or no deduction of pension contributions) draining resources in particular from those at the top of the income distribution
- In a lifetime perspective, pension-related TEs in Italy show a positive impact on lifetime income
  - in particular for low\medium educated women



Diffusion of III pillar and PenTEs