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THE FISCAL AND DISTRIBUTIONAL IMPACT OF PENSION-RELATED TAX EXPENDITURES IN THE EU

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OVERVIEW

- Policy discussions on pension systems have so far given relatively little attention to the tax treatment of pension contributions and pension benefits.
- To fill this gap, we analysed the fiscal and distributional impact of tax expenditures related to public and private contributory pension schemes, affecting both contributions and pension benefits, in 28 European countries. We take a microsimulation approach, using the EU-wide microsimulation model EUROMOD, to evaluate how tax expenditures interact with the broader provisions of the tax-benefit systems across EU Member States
- We find that pension-related tax expenditures can have a sizeable impact on revenue and strong effects on inequality and poverty. Tax expenditures tend to be progressive on two levels: first, among pensioners, by favouring those with lower incomes, mainly because of the preferential treatment given to pension incomes; second, among people of working age, through a partial or no deduction of pension contributions, draining resources from those at the top of the income distribution. Also, embracing a lifetime perspective, tax expenditures tend to redistribute resources in favour of women and low educated individuals.
- The evidence provided in this paper can offer valuable insights into the redesign of the overall fiscal benefit systems in an attempt to make it more functional and to harmonize the tax and pension system rules.

Research findings

Despite the wide use of tax expenditures across EU Member States, governments put little effort into investigating their real weight in public budgets and, above all, their fiscal and equity impacts.

Our analysis is a first attempt to provide a cross-country comparable quantification of the fiscal and equity impacts of pension-related tax expenditures, which, in some circumstances, could effectively replace social policy programs.

We take a microsimulation approach, using the EU-wide microsimulation model EUROMOD, to evaluate how tax expenditures interact with the broader provisions of the tax-benefit systems across EU Member States. Also, we adopt an exempted-exempted-taxed (EET) benchmark system, in which pension contributions and revenue accruals are exempt and taxes apply when benefits are received.

The empirical contributions are twofold. First, we discuss the fiscal effects of pension-related tax expenditures and the redistributive patterns observed across individuals in each country in 2017, our reference year. Second, we provide a quantification of the life-cycle dimension by adopting an approach derived from the generational accounting literature.

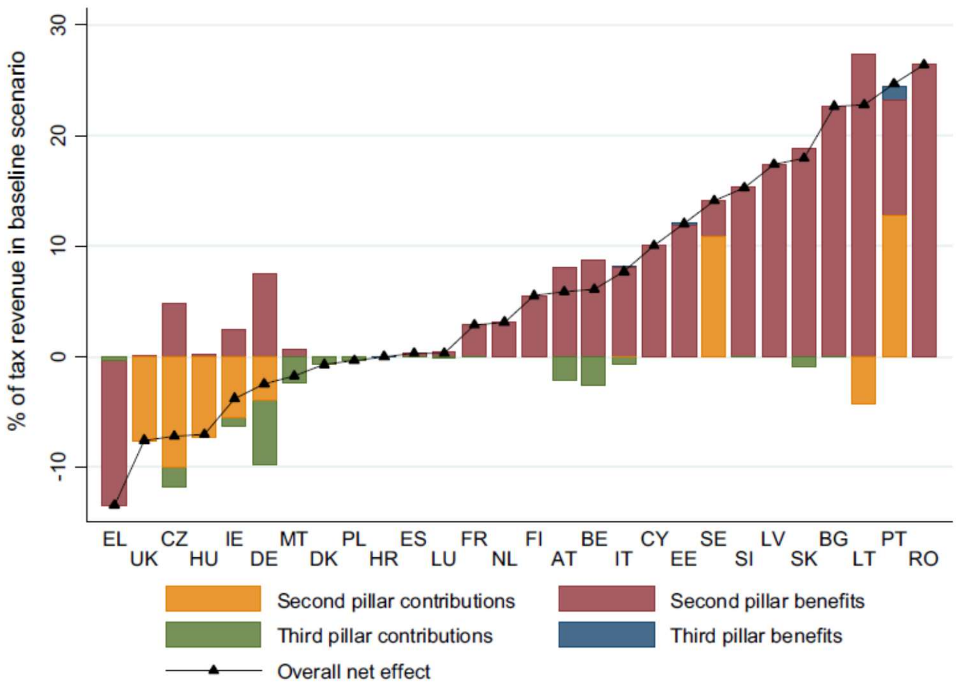
Our analysis starts from comparing each Member State's current tax regime (i.e. baseline scenario) with the benchmark system (EET). We find a high level of heterogeneity for the tax treatment of pension contributions and pension benefits across EU countries.

The empirical analysis suggests that the revenue impact of pension-related tax expenditures can be sizeable as shown in Figure 1, ranging from -13% of the baseline tax revenue in Greece (where tax expenditures represent a revenue gain) to around 10%-20% in countries such as Austria, Belgium, Italy, Sweden, Slovakia and up to +26% in Romania (where tax expenditures represent a revenue cost).

Moreover, and partly in contrast with the available empirical evidence outside Europe, pension-related tax expenditures tend to be progressive, as shown in Figure 2, at two levels: first, through a favorable tax treatment of low pension incomes, and, second, draining resources in among working age individuals at the top of the income distribution.

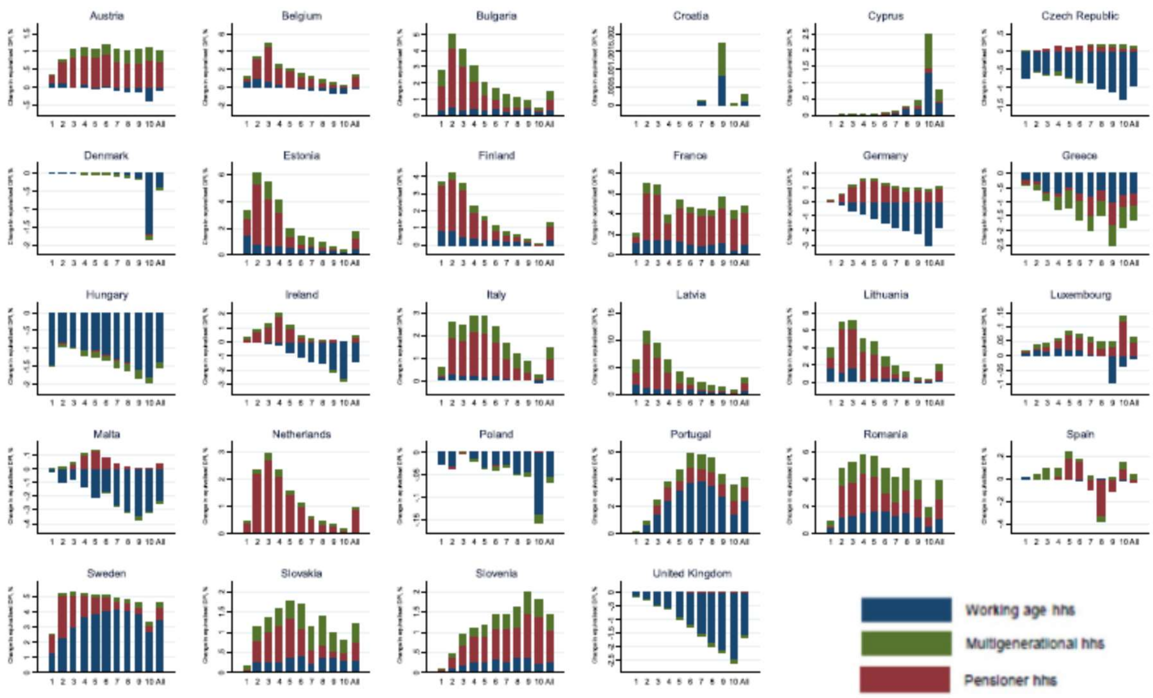
Across countries, pensioners take advantage of pension-related tax expenditures (mainly through tax relief on pension incomes), with a stronger positive impact on disposable income in the lower-middle part of the income distribution.

Figure 1. Revenue cost of Pension-related Tax Expenditures, 2017.



By contrast, working-age households, in particular, in the middle-top part of the income distribution, are penalized by pension-related tax expenditures (mainly through non-deductibility of social contributions) in all countries where this produces a net gain in terms of revenue, as well as in Austria and Germany. Also, embracing a lifetime perspective, we find that tax expenditures tend to redistribute resources in favor of women and low educated individuals.

Figure 2. Changes in disposable income by household type and decile group due to Pension-related Tax Expenditures, 2017.



Source: Authors' simulations with EUROMOD H0.34. Tax expenditures measured comparing the baseline with E-T counterfactuals

Policy Implications

The recent economic downturn has seriously aggravated the underlying challenges posed by ageing, and more needs to be done to improve the efficiency of pension schemes across Europe (European Commission, 2010). The capacity to guarantee the adequacy and sustainability of pension systems will also depend on their interaction with the overall tax-benefit system.

The role of tax expenditures, which are particularly effective in decreasing overall inequality and poverty rates among elderly people, will become even more relevant, with more of the financial risk being borne by private individual pension plans and with reduced redistribution in favor of lower-income individuals through public pension systems.

As can be seen from the size and redistributive effects highlighted in our empirical analysis, the limited attention paid by the public to pension-related tax expenditures stands in clear contrast to their relevance.

Policy Recommendations

The evidence of our analysis can offer four main reasons for redesigning the fiscal treatment of the pension systems.

First, an analysis of pension-related tax expenditures, including potential reforms to these, should be performed. In particular, the implications for net disposable incomes should be considered because pension-related tax expenditures might trigger important redistributive and fiscal effects in progressive tax systems.

Second, current pension-related tax expenditures are sizeable and weigh on both short-term budgetary constraints and the long-term sustainability of public finances, which also indirectly affects the viability of pension systems.

Third, pension-related tax expenditures resulting in relevant changes to disposable incomes might influence not only individuals' spending and savings (including pension contributions), but also their work and retirement decisions. Thus, tax reliefs give a clear message to individuals, with indirect wider economic consequences for the long-term sustainability of pension systems.

Fourth, pension-related tax expenditures act as a major redistributive mechanism from a life-cycle perspective, especially in cases where these tax rebates do not match future pension benefits, as is often likely to be the case.

In particular, current pension-related tax expenditures can be perceived as too generous if public services are expected to be financed by future rather than current tax payers, as in current PAYG systems. From these different perspectives, the use of the tax instrument, together with reforms affecting pension regimes, would be warranted in order to address the long-term sustainability of pension systems.

Further reading

"Size and distributional pattern of pension-related tax expenditures in European countries", by Salvador Barrios, Flavia Coda Moscarola, Francesco Figari and Luca Gandullia, CIRCLE Working Paper n. 4, Nov. 2018; forthcoming in *International Tax and Public Finance*.