Role of tax incentives for increase in personal pensions saving

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Abstract

Personal pensions increase their role in the retirement savings in the European Union. The design of the personal pensions is of great importance for the success of the saving. In the European Union there is no common legislation on the taxation of pensions. In recent years, the personal responsibility of savers for making decisions to save for retirement has increased. The limited ability of public pension systems to guarantee an adequate and sustainable income after working age necessitates the search for opportunities to fill this "pension gap". That is why the market for long-term savings products is central to achieving adequate income replacement and maintaining the standard of living of the elderly. This is one of the reasons for the greater role of the tax treatment of the savings products. The paper is analyzing the role of tax incentives for the increase of the saving in personal pension products. The study is searching answer which are the most important steps for efficient tax policy of retirement savings products. The new product on the European Union market, the pan-European personal pension product, sheds extra light on the topic of the importance and the efficiency of the tax treatment of saving in personal pension products. The research finds out that favourable tax treatment for saving in personal pension products is a must but it has to be major part of the overall social welfare and tax policy of the member states.

Keywords: tax incentives, taxation of pension, personal pension products.

Introduction

Personal pensions increase their role in the retirement savings in the European Union (EU). The design of the personal pensions is of great importance for the success of the saving. The tax treatment of the saving is part of the design. The taxation of savings is very important element of the legislative framework. In the EU there is no common legislation on the taxation of pensions (EIOPA's (European Insurance and Occupational Pensions Authority) advice on the development of an EU Single Market for personal pension products, 2016).

The tax reliefs are sometimes crucial for taking decision whether to save. The tax treatment can influence the decision which product to choose, how much to save and the preferred out-payment.

The new product on the EU market, the pan-European personal pension product (PEPP), sheds extra light on the topic of the importance and the efficiency of the tax treatment of saving in personal pension products. Very important part of the design of the PEPP is the tax treatment of the three flows related with the saving: the in-payments (contributions); the investment returns (the yields from asset management) and the pension benefits (out-payments, pay-outs). The Regulation on PEPP (European Parliament, Regulation (EU) 2019/1238 of the European Parliament and of the Council of 20 June 2019 on a pan-European Personal Pension Product) enters into force in August 2020. In 2021 EC approves the additional legal instruments (the so-called Level 2 PEPP legislation). It is expected that the tax treatment is of great importance whether the product will be attractive to customers and financially feasible to providers.

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Material and methods

The aims of the research are reached through the following methodology: analysis of the role of the tax incentives for saving in personal pension products; description of the current situation and trends in the markets of retirement savings; review of the policy in the sphere in the EU; exploration of the literature on the topic; discussion of how to incorporate the taxation of pensions in the overall tax policy and social welfare policy.

The problem of the impact and efficiency of the tax incentives for saving in personal pension products is analysed by numerous authors. The need to expand saving in supplementary pensions and the importance of the taxation on private pensions are analysed by Whitehouse (2005), Antolin et al. (2012), Hinz (2009) and others.

Different factors are affecting the development of saving in retirement plans. The financial incentives can make the saving in voluntary pension plans more attractive in terms of "higher net rates of return (resulting from favourable taxation)" regardless the low interest rates (Marcinkiewicz, 2017). The effects of tax-based saving incentives on contribution behavior from the introduction of the Riester scheme in Germany show that the government has control over the contribution behavior and that people react to the changes of the amount of the tax advantage (Kuper & Schmidt, 2016).

From the perspective of the consumer, the exact structure of the tax system has a significant impact on their incentives to save in a personal pension product. So, it is important whether the fiscal incentives lead to the creation of additional savings, or merely to displacement from other forms of saving for retirement. For instance, a recent study on the German Riester (Börsch-Supan et al., 2012) showed that they are complementary to other forms of savings, and therefore the tax incentives provided by government can be seen to assist in achieving the goal of greater savings for retirement. At the same time some researches (Corneo et al., 2008) are casting doubts on the effectiveness of the Riester scheme in raising private savings. These authors call for enhanced systematic efforts to evaluate that policy.

Some authors (Rutecka-Góra et al., 2018) justify that non-financial incentives is more efficient tool in terms of increased pension coverage compared to tax incentives. There is theoretical discussion how effective are the tax advantages, which type of financial incentive to apply. 85% from the people are passive (Chetty et al., 2012). Tax advantages upfront requires active position from the saver. So, the tax advantages trigger increase (according to the authors) in the saving of only 15% from the people.

Another authors (Carbonnier et al., 2014) find out that the deduction scheme is effective in boosting the demand for annuity of the high-income people, especially for those aged 45 and above. The effects of the applied tax policies are analysed by Amariei (2018), Hooghiemstra (2020), Van Meerten et al. (2017). The importance of the type and manner of disclosing information about the taxation effects is analysed by Dimitrov (2020).

Papers that include positions about the taxation of pensions expressed many institutional bodies such as AAE (Actuarial Association of Europe, 2020), Aviva (2016), Better Finance (2020), EFAMA (European Fund and Asset Management Association, 2020), EIOPA (2016), European Commission (2019), E&Y (2017), Insurance Europe (2020), Pensions Europe (2020), London School of Economics and Political Science, Open Evidence and BDI Research (2020), OECD (Organisation of Economic Co-operation and Development, 2020) and others.

Results and discussion

Based on the analysis reached is the conclusion that favourable tax treatment for saving in personal pension products is a must but it has to be major part of the overall social welfare and tax policy of the member states.

In recent years, the personal responsibility of savers for making decisions to save for retirement has increased. The limited ability of public pension systems to guarantee an adequate and sustainable income after working age necessitates the search for opportunities to fill this "pension gap". That is why the market for long-term savings products is central to achieving adequate income replacement and maintaining the standard of living of the elderly. This is one of the reasons for the greater role of the tax treatment of the savings products. The tax treatment of pensions "…is a critical policy choice…" (Whitehouse, 2005).

There is a pension shortage (pension gap) in the EU. Estimates show (Aviva, 2016) that additional savings of more than € 2 trillion a year, or 13% of EU GDP, are needed to fill this deficit. This trend is even more vivid in the countries of Central and Eastern Europe (CEE), where the insurance under employers' pension plans (occupational pensions and quasi mandatory pensions) is significantly lower than in the other EU member states.

The most commonly considered solution for filling the pension deficit is to increase the share of supplementary pensions. In this context, the EU builds the framework of a personal pension product (PEPP). The aim is to increase the people who save in personal retirement products.

Personal pension plans in the EU cover 67 million people (EIOPA, 2016), or 27% of the Union's population aged between 25 and 59. The saving in the personal pension plans is provided via 72 products. The assets under management are worth more than € 1.1 trillion. From the point of view of the saver, efficiency is measured mainly in the form of the expected sum to receive at the end of the saving compared to the contributions invested at the beginning. Tax reliefs help to increase the financial effect from the saving. The consumers' association, Better Finance, uses the term "tax efficient" when describing the expected features of PEPP. Historically the tax incentives have been the dominant form of the fiscal incentives. Generally, they provide favourable income tax treatment to savings for retirement relative to other forms of savings. Other types of financial incentives are not linked to the income tax system. Such other types are matching contributions and fixed nominal subsidies

In the PEPP framework the European Commission (EC, 2017) has a recommendation to the member states to treat the PEPP product the same way the national personal products are treated from the taxation point of view. In the PEPP regulation the conditions in the accumulation/decumulation phase are not prescribed (Amariei, 20018) in all aspects in order to allow providers to adapt to national laws and meet the criteria for tax relief. According to Hooghiemstra, 2020 the "soft law PEPP tax recommendation" and "…resolves tax discrimination. This instrument, however, does not resolve system diversities of the various tax systems."

The overall strategy for development of the market for personal savings could be linked with the national policy for capital markets development. One point of view is that if there are no well-developed financial markets decisions makers will not be positive to grant high tax reliefs. The reason is that the accumulated sources from voluntary contributions will be invested out of the country. This is in doubt controversial issue because the investment income is accrued in the savings of the local savers and also local pensioners will benefit from the pension payments. The vast part of the pension payments will be spent in the national economy. Another point of view is that through the development of private pension insurance could be seek greater activity and development of the local financial markets. The logic is that pension funds will invest the accrued sums in financial instruments of the local companies that are traded on the registered markets.

Favourable tax treatment for the contributions compared to the pension's benefits empower the transparency of the product. Long-term nature of the product requires transparency in order to convince the potential saver to buy it.

Very important for the perception of the tax advantages from the potential savers are the trust and the supplied information. The lack of sufficient consumer trust is raised as a problem concerning the reasons the EC to develop the PEPP (London School of Economics et al., 2020). 57% is the trust by consumers in financial products and financial institutions according to Edelman Trust Barometer – the lowest among 10 categories.

For the sake of the savers, it could be positive to announce periodically the volume of the annual tax reliefs in absolute sums, the number of people who took advantage of the tax reliefs, the benefitted tax advantages by type of income, by income groups, number of people that use the maximum tax advantage and others. Another measure is to visualize the potential tax advantage when providing tax declaration. Stressing about the tax advantages opportunities before the fiscal year could be another positive measure. All the mentioned is a way to encourage people to save and to benefit from the tax advantages. Also, this is a sign that the government supports the favourable tax regime and encourages saving in personal retirement products.

It is important to have the opportunity to apply the tax relief monthly as well as at the end of the fiscal year. This is a way not to overpay the tax and after that to file tax declaration and gain the saved tax in the next fiscal year (after filing the tax declaration).

Another fiscal stimulus, except financial tax reliefs, could be matching contributions. The matching contributions correspond to a certain proportion of the individual's contributions. This proportion is the match rate. Examples of matching contributions are presented in the next table.

Table 1 – Government non-tax financial incentives, 2018

matching contribution (match rate)	fixed nominal subsidies
Austria (4.25%), Czech Republic (scale), Hungary (20%), Croatia (15%)	Germany, Lithuania

Source: OECD (2018). Pensions Outlook 2018, p. 46.

In the case of Austria, the matching contribution is a fixed rate of 2.75% plus a variable rate depending on the annual general level of interest rate. For 2020, the variable rate is 1.5% (OECD, 2020). As of 1 January 2020, the maximum personal contributions considered to calculate the government contribution is EUR 2 957.80 thus setting the maximum government matching contribution for 2020 of EUR 125.71.

The maximum subsidy is EUR 175 per year and per person in Germany for Riester plans members. Partners' and child's subsidy is also available for Riester members. The maximum subsidy amounts to EUR 185 per year and per child born before January 1st 2008 or EUR 300 per year and per child born on or after January 1st 2008. It is interesting another encouragement measure: Riester members with first government subsidy before their 25th birthday, receive an additional maximum one-time bonus of EUR 200.

We can conclude that tax advantages for the contributions in personal pension products are vital for the start of the saving. As Actuarial Association of Europe states (2020) "*…in order to provide an adequate retirement income, it is necessary to pay an appropriate level of contributions; the investment strategy alone cannot deliver this*".

This taxation of investment returns is with the lowest impact on the decisions of savers concerning personal retirement products. This is a fact that stem from two reasons. First, tax advantage on investment returns is less well perceived compared to tax reliefs on contributions or benefits. Second, savers often consider the distributed investment yield as a net result no matter whether it comes after investment fees or income taxes.

In a situation where there is a taxation on the investment return, it could be imposed differentiated tax. The different treatment could be based on the number of years of holding the investments, the type of the assets or the income of the saver.

Some products allow early withdrawal of sums. This right could be without conditions or after meeting certain criteria. The amounts withdrawn are taxed under local tax legislation. The logic is if for the contributions are benefitted tax advantages as a consequence the early withdrawn sums to be taxed proportionately. The total sum withdrawn could have part of distributed investment returns. There are products that do not impose tax on investment yields withdrawn before retirement. From one hand, such preferential treatment increases the trust, the transparency, the liquidity of the retirement product. On the other hand, it could diminish the accrued sum and future pension entitlements which is in contradiction of the nature of the product.

Often the tax treatment of investment returns on retirement products is compared to the taxation of similar flows in alternative products. One example is the interest on deposits. Another example is the technical interest and additional investment yield to life insurance products. Such comparative taxation analysis has to take in mind the different factors that influence the saving in different types of long-term products and the guarantee mechanisms that are behind each separate product. The tax on interest of deposit often is regarded as a way to encourage people to invest more actively their spare money not to save "passively" in bank deposits.

Another policy approach could be to apply different taxation on the investment options. Applying different taxation could be a policy to encourage the saving in specific investment option, in specific investment portfolio, promoting low fees, encouraging low risk profile or others. The policy to encourage the saving in specific underlying portfolio could be regarded as an example of pursuing green policy, supporting ESG (Environmental, Social and Governance principles) portfolio or others.

Private pension schemes usually offer several types of benefits (pay-out options, decumulation payments). These options are life annuity, programmed withdrawal, lump sum or combination of more than one of the previous options. Information about the product features concerning the out-payments is presented in the following figure.

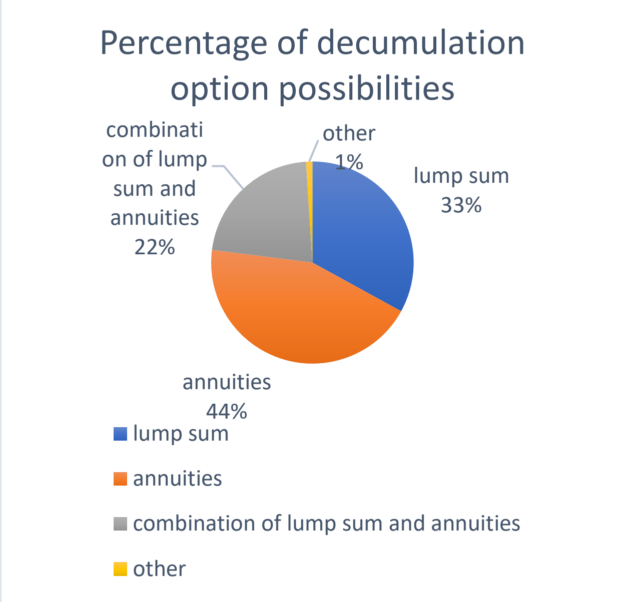

Figure 1.

Source: E&Y (2017). "Study of the feasibility of a European Personal Pension Framework", p. 36.

The figure above shows that annuities is the most widely offered payment option in personal pension product – with 44% share. Second most offered option is the lump sum payment – with 33% share. The combination of lump sum and annuities comes third with 22% share. Other options have 1% from the decumulation option possibilities of personal pension products.

The tax treatment of pension income is usually identical across different types of pay-out options. Some countries, like Czech Republic and Estonia, apply more favourable tax treatment for annuities as compared to programmed withdrawals. This is a way to incentivise people to annuitize their pension income. Another applied policy is to levy no tax on lump sums to a certain amount or only to be partially taxed.

For the personal products it is important to be liquid product – in case of certain situations before retirement the saver to be able to withdraw (the so-called early withdrawal) the accumulated capital (or part of it). It is logical if the saver has benefited from tax exemptions for the contributions the early withdrawal sum to be taxed. This scenario is confirmed in nearly 80% of the product (E&Y, 2017).

The fiscal stimuluses are part of the overall tax policy of a country. Some of the elements of the overall tax policy are the existence of family reliefs, coverage of tax advantages to various types of income, policy options for increased tax advantages for lower income groups, relations tax base, compulsory contributions and tax rates, strategy for the evolution of the tax system and others.

The tax advantages can be spread out not only to labour income but also to income from real estate (rent and capital gain), income from financial instruments (dividend and capital gain), some kind of social or labour compensations or indemnities. Another milestone is to give possibility to gain the tax advantage for self-employed and for income from non-labour contracts.

Other policy option is to apply family tax reliefs. That means that there is favourable tax treatment in favour of a family member. In economies that has uncertainty in career and uncertainty in the labour income this is regarded as a solution to increase the coverage and to decrease the inequalities in gender and in income.

It is interesting to see the relation between type and depth of the tax exemptions with the success of a personal pension product. For the measure of the "success" we will use the market penetration index (MPI) developed in the E&Y 2017 study (pp. 185-186). The five products with the highest market penetration index are Riester from Germany, the Spanish IPP, the Belgium PP, the Danish RP and the Austrian PZV. Riester (Riester-Rente) is a government subsidised pension saving product. IPP is an individual personal pension plan (Plan de pensiones individual). PP (Pensioensparen) is a pension savings plan. RP (Ratepension/Ophorende livrente) is an annuity pension plan. PZV (Prämienbegünstigte Zukunftsvorsorge) is a state sponsored retirement provision. Three of products (Riester, IPP and PP) fall to EET (E – exempt, T – taxed) category. RP is ETT taxation scheme and PZV is EEE label. The explanation for the highest MPI of the five products is different. One common feature is the "exempted" in-payments for the five products. In the study there is a conclusion that *"…the main driver of consumer choice when it comes to personal pension product investment appears to be tax incentives"*. And further "*…when tax incentives increase by 1%, the penetration index (or the propensity to consume a personal pension product) gains 6 points on average*".

An element of the consumer trust in personal pension products is the possibility to transfer (switching) between providers without penalties. This transfer can be regarded in two directions – domestic and cross-border. The domestic switching is between providers in the same state. The cross-border switching is transfer to provider from another state. The taxation of the transfer is of great importance. The imposed tax is considered as an obstacle and as a cost to the transfer. It has to be taken into consideration that when allowed the transfer can be subject to any fees. The possible fees are not analysed in the current chapter. No tax impact following the domestic switching is envisaged in almost 84% of the personal pension products (E&Y, 2017). In the cases of three products (from Belgium, Latvia and Luxembourg) the domestic switching triggers immediate taxation. For five products (from Cyprus, Germany, Malta and Slovak Republic) the domestic switching is not allowed.

Relatively the same is the taxation in cross-border switching. In the cases of five products (from Belgium, Latvia, Luxembourg and Ireland) the cross-border switching triggers immediate taxation. For fifteen products (from twelve states) the cross-border switching is not allowed.

The tax treatment can be different for different products based on certain criteria: the type of the provider; the duration of the contract; the aim of the contract – savings or investment; the type of the guarantee; the risk nature; the underlying investments and others. The applied policy options can have the aim to encourage saving in a specific product. The chosen from the government policy is part of the overall social welfare strategy.

For example, one policy option is to encourage savers to save in a capital protected products. The capital protection for the PEPP can have the form of a guarantee (guarantee for the accumulated contributions after costs) or the form of applied risk-mitigation technique (RMT). The PEPP Regulation sets out the requirement for all PEPP investment options to include a risk-mitigation technique. This requirement is supposed to secure high level of protection. The savers can choose a guarantee or RMT. Here comes the first problem – there are no clear criteria to assess the effectiveness of the RMT. In this regard, it is important to apply an algorithm of risk assessment operations, including determining the stages in the risk assessment process.

Taking the occasion of PEPP framework the social welfare policy can have focus on specific financial institutions – providers of personal retirement products. The possible PEPP providers are generally insurers, pension institutions, asset management companies and banks. Those groups of providers have different business models. They all need to have at least Basic PEPP. It will be difficult for the saver to compare between Basic PEPPs from different types of providers. The policy of pensions taxation can give competitive advantage of one personal retirement product to another (provided from different type of financial institutions).

Another policy option is the tax treatment to be favourable for products which are part of national guarantee scheme. For the PEPP in the section in KID (key information document) „*What happens if (the name of the PEPP provider) is unable to pay out?*" shall have description on whether the related loss is covered by an investor compensation or guarantee scheme. This information is very important for the savers' choice and behaviour. The saver has to take into account whether some part or the whole amount of the savings is under protection from national guarantee scheme. In some countries life insurances and bank deposits are guaranteed up to certain level under sectoral guarantee schemes. At the same time savings in voluntary pension funds and in mutual funds are not protected under national guarantee scheme.

Another policy option is favourable tax regime to be granted for products which have high level of providers' prudential rules. For the saver's security stricter rules are better. Higher capital and governance requirements lead to increased price for the private capital to participate in the market. It is said that life insurers have stricter prudential rules compared to asset managers. This could lead to prudential rules arbitrage.

We can view the favourable tax treatment as part of the standardized features in pension savings products. Using standardized features and measures for quality assurance EC is expecting increase in personal pensions savings.

When there are different sectoral legislations raises the question how to apply the same tax treatment. Logic dictates that tax treatment will follow the specific sectoral legislation. If for the saving in mutual funds there are no tax reliefs so for the PEPP provided by the investment company also is applied neutral tax treatment.

This could be a part of the solution for the personal pension savings coverage. High coverage rate is considered as one of the main factors for success of the personal pension product.

In this context for the success of the policy option it is very important the transparency of the product. Crucial indicator for the transparency is the comparativeness between PEPPs and PEPP with alternative products. That is why it is needed clear and easy to understand information, including taxation. User-friendly tools, calculators and others will help for the success of the product.

Other elements of the transparency are the compulsory informative documents KID and PEPP BS (benefit statement). The tax regime of saving in PEPP is not well presented in KID and PEPP BS (Dimitrov, 2020). On the contrary opinion is Better Finance (2020) which says that the applicable tax regime should not be detailed in KID. The lack of sufficient information about taxation of the pay-ins, investment yield and pay-outs lead to low comparability between PEPPs and PEPP and alternative products. Little information about tax regime has to be disclosed only in the section „*What can I expect at retirement*" in the KID.

Positive influence on the PEPP Level 2 legislation is the carried-out testing among consumers (London School of Economics et al., 2020) of KID and BS mock-ups. The communication design, behavioural studies and consumer testing stand as a very valuable in product design. Valuable information from this testing is the influence of particular factors in both ways alone each other and in combination: security guarantee; annual cost (1%); risk profile (low or high); quality assurance (EU flag); social nudge and reward projection. Examples of social nudge are "very popular product", "many people are buying" and "friends' recommendation".

The tax regime of the personal pension saving could be used to reduce the income inequality of the elderly. The tax reliefs could be differentiated based on level of income, types of income, the amount of the contribution, the amount of the pension benefit and others. Those problems could be solved with combination of reliefs between absolute values and relative terms.

There is no common policy for tax reliefs in the CEE countries. Bulgaria, Croatia, Romania, Lithuania, Latvia, Estonia, Czech Republic, Hungary, Poland, Slovenia and Slovakia. This fact shows that countries with similar socio-economical conditions apply different policy options.

Table 2 – Taxation on saving in personal pension products in CEE countries

country / flow	contributions	investment returns	benefits after retirement
Bulgaria	E	E	E
Croatia	T	E	E
Romania	E	E	T/PE
Lithuania	E	E	E
Latvia	E	10%	E
Estonia	20% credit	E	E
Czech Republic	T/PE	E	E
Hungary	T	E	E
Poland_IKZE	E	E	10%
Poland_IKE	T	E	E
Slovenia	E	E	T
Slovakia	T/PE	19%	E

Source: OECD (2020). "Financial incentives for funded private pension plans. OECD OECD country profiles" and E&Y (2017). "Study of the feasibility of a European Personal Pension Framework".

Greater tax reliefs require more active government policy. The active government policy could take the form of detailed regulations, higher capital requirements, sophisticated supervision, medium- and long-term targets, adequate and regular information, appropriate statistics, periodic analyses and others. Other tools could be customer survey, analysis from independent parties. Based on the periodic analyses of the results of the pension system can be taken decision for changes, including evolution of the tax treatment of the personal pensions.

The tax regime has to be part from the overall social policy. If the income replacement ratio is low the government could encourage saving in personal retirement plans by tax reliefs. The existence of maximum pension from PAYG system may encourage saving in voluntary personal pension plans. Contrary, high amount of minimum pension from PAYG system discourages saving in voluntary personal pension plans. When there is not sufficient trust the policy-makers have to execute active policy. The favourable tax treatment is part of the active policy.

Conclusions

The tax treatment of personal savings products is an important milestone of the accumulation of savings. Favourable tax treatment is regarded as a sign from the government that increases the trust in the particular saving product. In addition, favourable tax treatment is part of the social nudge that encourage potential saver to make a decision.

When granted tax reliefs increase the responsibility of the regulators and supervisors. People tend to believe that tax reliefs are because of the active role, active policy and positive attitude from the authorities towards specific savings product. The decision which types of tax relief to grant is within the power of the authorities.

Stable and consistent tax reliefs policy is a must in the social and economic policy. This a step to increase the overall savings, with focus on personal retirement savings.

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