Taxing Pensions: Cross-country Differences and International Co-ordination

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How the tax treatment of public pensions and other instruments of old-age provision effectively differs across countries is an interesting topic in itself – certainly for those who are interested in the design of tax systems at a national level as well as in a comparative perspective. The progress of economic integration adds a new dimension to this theme. With the increasing intensity of cross-border activities of firms and their employees, including the cross-border activities of those who offer relevant types of financial services, differences in taxation potentially influence many of the numerous decisions involved in these international operations. In particular, this is considered an issue for EU member countries, where legal entities and individuals are now rather free to operate and locate themselves within the European Single Market.

Not surprisingly, EU level authorities have started to address the problems that may arise from the coexistence of different systems of old-age provision and different national tax codes in a process of consultation and communication that has so far generated a limited number of official statements and directives. The general approach applied to solving these problems on this level is the so-called "open method of co-ordination" (as suggested in the proceedings of the European Council Meeting in Lisbon; European Council 2000, No. 7), while the precise direction to be taken in related efforts is still open (see European Commission 1999, 2001).

Against this background, the task of this article is twofold. First, we will briefly survey the national systems applied to taxing pensions and other instruments of old-age provision across the countries of the EU-15, plus the US and Switzerland. Second, we will discuss the main reasons why, from an economic point of view, a higher degree of co-ordination might be useful in this area, and what the current stage of affairs really is in terms of EU-level decision making on this issue. The article draws heavily on a study prepared by Fenge et al. (2003), where features of national pension systems were covered in a much broader perspective, including their tax treatment and the problems involved in tax design at both a national and an international level.

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Taxing pensions: a classification of national systems

Basically, there are three types of transactions that constitute a pension scheme and thus provide an opportunity for possible taxation: *(i)* contributions or premiums paid to the scheme; *(ii)* income derived from accumulated wealth, if any; and *(iii)* benefits received or withdrawals made during retirement. Accordingly, a widely used set of short forms that can be used to characterise national taxation regimes is given by three-digit combinations of the letters *T* (for "taxed") and *E* (for "exempted"), representing the treatment of transactions at all the three stages mentioned before (see, for instance, Dilnot 1992, or Whitehouse 2001). For example, *"T E E"* is the short-hand for a system where contributions are taxed, while returns to investment and pensions are tax-free; *"E T T"* denotes a system where contributions are tax-exempt, while fund income and benefits are not.

The taxonomy introduced here has been originally suggested for occupational pension plans and other forms of private old-age provision. When it is applied to public pension schemes, minor modification are therefore useful. As, throughout the world, public pensions are largely unfunded – or as existing funds are virtually nowhere attributed to individual accounts – taxing capital yields is not an option here. For this reason, two-digit combinations like *"T – E"* or *"E – T"* would form an analogous set of abbreviations for public pensions. In fact, there is even a considerable number of public pension schemes that are financed from the general government budget and, hence, do not even involve any ear-marked contributions that could be subjected to, or exempted from, taxation. In

these cases, *"– – T"* or *" – – E"* are effectively the only two options available.

One of the main distinctions between the different tax regimes that are logically possible is whether, in terms of the conventional public finance literature, they correspond to a "comprehensive income tax" or an "expenditure tax". The difference between these two types of arrangements lies in whether fund income derived at the intermediate stage is taxed periodically – as it is considered part of an individual's comprehensive income tax base – or not. In the former case, the tax system does not affect decisions as to how the income is spent in a given period of time, in particular on consumption vs saving; in the latter, it encourages saving, but is basically neutral with respect to consumption today vs consumption tomorrow. From an economic point of view, this difference is much more important than whether taxation is mainly concentrated at the early stages of the accumulation process *(T E E* or *T T E)* or at later periods of time *(E E T* or *E T T)*.[1] On the other hand, the difference between the "income" vs "expenditure" tax approach is sometimes exaggerated (see, for example, Börsch-Supan and Lührmann 2000) when comparisons are made that are not neutral with respect to the present value of total tax revenues. If this is imposed as an additional constraint, the differential impact of the two regimes on labour supply, saving, economic growth, and other variables rets on a number of potential behavioural adjustments that are not easy to predict.

In the following, we will first of all apply the simple way of characterising national tax systems introduced before in order to illustrate existing differences with regard to how public pensions, occupational pensions, and fully private provisions are taxed in different countries. In order to assess the various systems, one should keep in mind that, as the general rule embodied in national tax codes, virtually all of the countries considered here apply some variant of an "income tax" (sometimes more, sometimes less comprehensive), not an "expenditure" or "consumption" tax. Thus, any deviation from this rule for pensions and other old-age provisions can be seen as favourable tax treatment.

[1] For practical reasons, imposing taxes early or later on can, of course, make a difference – for example, with respect to when public revenues are generated. Also, neutrality results with regard to the timing of taxation – at least for *TEE* vs *EET* or for *TTE* vs *ETT* – which are obtained in simple models need no longer be valid when complications like progressive taxation or inflation (and cold progression) enter the picture; see Fenge et al. (2003, ch.7). Here, we will not go into these details.

The treatment of public pensions

In the majority of cases, public pensions schemes are formally taxed according to an *E – T-type* rule (see table below). As a rule, the share of contributions paid by employers is considered part of the payroll and therefore reduces the firm's taxable profits; in addition, they are usually not treated as taxable income on the employees' side. Similarly, employees' contributions are usually subtracted from the individuals' income tax base and are thus made from income before taxes. Exceptions are Germany and Ireland, where the deductibility of employees' contributions is subject to an upper limit, and the UK and the US where contributions have to be made from income after taxes. Consequently, pension benefits accruing later on are mostly subjected to general income taxation in a way which, among other things, reflects how contributions were either taxed or went untaxed.

As public pensions are mainly unfunded and do not involve any capital yields that are attributable to individual tax-payers, *E – T* systems therefore appear to be basically consistent with the idea of a comprehensive income tax. In many cases, however, there are additional forms of tax breaks related either to the taxpayer's age or to "pensions" as a particular category of income. Sometimes, these allowances also vary by levels of total income, benefits, etc. As a result, public pensions are often to some extent, in the case of basic pensions even fully, exempted from taxation.

These qualifications imply that the short forms used in the table do not indicate everything that is worth knowing about the tax treatment of public pensions at a national level. For instance, the way things are represented for Germany does not reveal that public pensions derived from (less-than) average earnings are effectively tax free if they are the major source of retirement income.[2] Similarly, the information provided for the UK system should not be taken to imply that there is a true double taxation in the strict sense of the word in this country. Instead, tax liabilities are limited at both stages so that the total amount of taxes involved is basically not excessive. This should be taken as a general caution which also applies to the short forms used for the tax rules in other coun-

[2] Currently, Germany is considering the transition to an *E–T* scheme with a more stringent taxation.

Taxation of public and occupational pensions in selected OECD countries

	Tax treatment of	
	Public pensions	Occupational pensions
Austria	$E-T$	EET or TEE[e]
Belgium	$E-T$	EET
Denmark	$--T$[a] and $E-T$[b]	EET or ETT[e]
Finland	$--T$[a] and $E-T$[b]	EET
France	$E-T$	EET
Germany	E/T[c] – E/T[d]	EET or TEE[e]
Greece	$E-T$	EET or TEE[e]
Ireland	E/T[c] – T	EET
Italy	$E-T$	EET or ETT[e]
Luxembourg	$E-T$	TEE
Netherlands	$E-T$	EET
Portugal	$E-T$	EET
Sweden	$E-T$	ETT
Spain	$E-T$	EET
Switzerland	$E-T$	EET
United Kingdom	E/T[c] – T	EET
United States	T/E[c] – T/E[d]	EET

[a] For tax-financed basic pensions. – [b] For earnings-related supplementary pensions. – [c] Tax deductability of contributions limited. – [d] Taxation of benefits limited through special rules (not general tax allowances). – [e] Depending on the type of pension plan.

Note: The three-digit combinations used here to represent national tax rules indicate whether there is taxation (*T*) or tax exemption (*E*) of transactions at each of the following stages: (*i*) contributions or premiums paid to the scheme; (*ii*) income derived from accumulated wealth; (*iii*) benefits received or withdrawals made during retirement.

Source: Fenge et al. (2003, ch. 5 and 6).

tries as well as for the tax treatment of other types of old-age provision.

The treatment of occupational pensions

In the countries covered here, the dominant form of taxation of employer-based pensions is EET (again, see the table). The variant ETT is applied in Denmark and Italy for some types of occupational pensions, and in Sweden it is the standard treatment.

In virtually all the countries considered, contributions made by both employers and employees are tax-deductible at least to some extent. Again, most countries do not treat the employers' contributions as taxable income of employees. Note, however, the requirements that have to be met by a pension plan to qualify for this particular tax treatment are widely different across countries. Returns to investment and capital gains that arise from changes in asset prices are mostly tax-free. Only in some countries are they subject to capital income taxation.

Irrespective of whether accumulated wealth is annuitised or withdrawn as a lump-sum, all pensions paid out are generally included in the income tax base of the recipients. Tax rates and, eventually, tax breaks differ substantially between countries. In some countries, lump-sum payments enjoy a favourable tax treatment, while in contrast they are generally ruled out in others.

Austria, Germany, and Greece are the only countries where, as a deviation from the model described so far, the taxation follows a TEE-pattern for some types of occupational pensions; in Luxembourg, this is the standard procedure.

The treatment of private provisions

Including a discussion of the tax treatment of fully private provisions for old-age is difficult for several reasons. The most important problem is that virtually any kind of savings or wealth can serve as an instrument for old-age provision – even choosing an appropriate timing to buy consumer durables could be seen as a limiting case. Thus, looking at the tax treatment of private pension plans or annuities alone might be too narrow a view. (In fact, markets for financial products of these types are extremely thin in many industrialised economies because of the predominance of public provision and other types of saving.) On the other hand, different types of saving, or wealth accumulation, are often subjected to a very different tax treatment even within a country – often for reasons that are not, or not primarily, related to encouraging private old-age provision. A very prominent example, which is nonetheless important, also as a source of retirement consumption, is certainly owner-occupied housing and wealth in terms of real estate. Another one is the special rules that are meant to subsidise wage earners when investing in small shares of equity capital in general or in own-company stock in particular. As a consequence, including a broad array of instruments of private old-age provision in this investigation is next to impossible as it would lead us into a number of distinct areas of tax rules that would each deserve an in-depth treatment.

Pars pro toto, we therefore concentrate on the tax treatment of life-insurance contracts, including those that are annuitised in the pay-out phase. Across countries, products of this kind are rather uniform, even though the regulatory framework for insurance companies and other providers may

differ. Private life-insurance contracts and annuities are taxed according to *E T T*, rather than *E E T*, rules in the majority of cases. In other words, capital gains are mostly subject to taxation in this area. Also, even for the narrow set of instruments considered here, the tax treatment of private provisions is less uniform than in the case of the other pillars.

Taking *E T T* as the most wide-spread case, it should be mentioned that in Austria, Germany, France, Portugal, Spain and the US, tax deductibility of premiums is limited or even absent. Consequently, these countries – as well as Greece where premiums are tax-free – do not tax insurance benefits under a number of qualifying conditions, such as insurance period, form of payments, or age of the insured when benefits are paid out. Capital gains are tax-free in Austria, Finland, Greece and the Netherlands. All in all, insurance premiums are subsidised and/or benefits are subjected to special tax incentives in more than half of the countries considered, but the precise terms of the favourable treatment are very different and thus cannot be represented in the framework of our very simple scheme.

International co-ordination

Based on the rights to freely move goods, services, capital, and labour in the Single Market, economic integration of the EU is becoming more and more intense. Against this background, national systems of old-age provision can no longer be taken to be entirely separate institutions. Instead, they may create obstacles for further integration, thus contradicting the spirit of the 1957 ECC Treaty and openly violating current EU-level legislation. Effectively, the coexistence of different systems of old-age provision and different tax codes within the Single Market can run counter to all the four freedoms laid down in the EC Treaty.

Those who are affected by restrictions of the freedoms of the Single Market are insured individuals, their employers, and also financial intermediaries that are active in the relevant markets. In addition, any restriction which immediately affects just one of the freedom rights – free mobility of labour, for instance – potentially hits the full set of freedoms through effects on decisions taken by firms and their customers. Co-ordination problems which are mainly relevant for labour mobility arise from differing tax rules for old-age provisions, differing definitions of membership rules for both public and employer-based pension schemes and from difficulties regarding the portability of pension entitlements, including an effective non-transferability of accumulated wealth, on an international level. For first-pillar pensions, an EU-level legal framework of co-ordinating social law has been in place for quite some time now, effectively removing all major obstacles for labour mobility in this area. An analogous framework for occupational pensions is however lacking. In the following we will discuss in more detail the co-ordination problems of differences in the taxation of pensions.

Discriminating tax treatment

It is easy to see that differences in the acceptance of tax advantages with respect to domestic and foreign providers of old-age pensions are a source of potential restrictions for free mobility of services, labour, and capital. Discriminating tax rules mean that some countries provide tax advantages only for domestic pension schemes. This may hinder free mobility of workers if the destination country does not fully grant tax deductions of contributions to a pension scheme that the worker wants to maintain in his origin country. But also free mobility of services and capital can be obstructed if foreign suppliers of pension provisions have to fulfil special conditions in order to be fully accepted for tax deductions. In the communication KOM (2001) 214, the Commission posits that these obstacles to the Single Market shall be removed. The principle of "non-discrimination" offers a tool for EU-level authorities which can be applied to removing all barriers to labour mobility that are due to differing approaches to taxing old-age provision, including different conditions that have to be met in order to qualify a pension plan for a favourable tax treatment. Similar barriers that are relevant for a free flow of services cannot be tackled in the same way, as national legislators are fully responsible for occupational pensions offered inside their countries. Parallel problems that arise when insured individuals or insurance services move from one country to another thus have to be solved using different approaches. With respect to the latter type of problems, the Commission limits its activities to asking national legislators for a revision of tax rules which hamper cross-border

transfers of accumulated wealth as they may restrict the free mobility of capital.

Co-existence of differing tax rules

If instruments of old-age provision are taxed according to different rules, pensions accruing to mobile workers (or to pensioners who migrate after retirement) can be subjected to double taxation – or, possibly, even tax-free. The Commission therefore discusses several strategies which can be adopted to avoid these cases and help national tax authorities in effectively applying their tax codes without interfering with the freedoms of the Single Market. So far, there is no final conclusion as to what strategy is considered preferable.

Lacking both the responsibility and the ambition for a true tax harmonisation, the Commission states it would be desirable if a larger number of EU countries were to adopt an *EET* approach to taxing instruments of old-age provision. Obviously, this would facilitate co-ordination. But *EET* taxation can adopt a variety of forms in different countries. For example, in some countries the amount of tax-deductible contributions to occupational pension schemes is made dependent on the contributions to the public pension system. Different preferences of the EU member states with respect to the structure of the old-age pension schemes and the relation between public and occupational pension schemes may result in significant differences in the amount of tax-deductible contributions. A standardisation of the taxation of pensions according to the *EET* rule would therefore not fully succeed in removing impediments to mobility. In addition, the rules of the tax-deductibility of contributions, capital gains, and benefits would have to be harmonised across countries in order to allow for a perfect liberalisation of mobility.

As an alternative, bilateral agreements (in the first place, existing tax conventions or double taxation treaties) could be used to find solutions that are geared to particular co-ordination problems arising in a specific context. The advantage of bilateral agreements is that the specifications of each two pension and tax systems can be taken into account and co-ordination is much easier than under multilateral or community-wide arrangements. On the other hand, negotiating and adapting the multitude of mutual agreements that would be needed could turn out to be very costly, and a uniform treatment of identical cases still is not guaranteed. This is true even if the majority of existing treaties is based on the OECD Model Tax Convention, which establishes a different tax treatment for the three pillars of typical old-age protection systems. Double taxation treaties between Germany and other EU countries generally stipulate that occupational pensions and private provisions are taxed according to the country of residence, pensions accruing to public sector employees and civil servants are taxed in the source country, while other public pensions are taxed in either of these countries depending on the particular case.

Taxation in the source country or residence country?

From an economist's point of view, returns on investments in old-age provision should be taxed in the country of residence – provided that a taxation of capital gains is intended at all. The reason is that this leaves investment decisions unaffected. This holds true for private old-age provisions where the person with pension claims is able to decide in which country the investment takes place. If this is not the case, as in occupational or public pensions schemes, where either the employer or the state undertakes the investment decision it is more appropriate to prevent the option of pensioners' evading the tax burden by moving abroad. This can be done by a taxation in the source country where the pension wealth will also be taxed even if the pensioner has moved to another country.

As to the taxation of either contributions or benefits, none of the two approaches that are feasible turns out to be neutral with respect to the potential mobility of tax payers. Taxation in the source country may distort migration decisions taken by workers in their active period of life; taxation in the residence country may distort choices of residence after retirement. Thus, as Richter and Wiegard (2001) put it, "distortions of the choice of the working place have to be weighted against distortions of the choice of residence in retirement". In combination with an *EET* approach, implying that taxes imposed on transactions with a pension plan are effectively credited until retirement, taxation in the source country is the only way to make sure that tax authorities finally get "their" money. At the same time, taxation in the country of residence is desir-

able to the extent that taxes are meant to remunerate the public sector for the extra-cost associated with an additional resident. If there are good reasons for taxing pensions paid across borders in any one of the two or more countries involved, while double taxation should be avoided, then splitting the right to tax between source and residence countries might be an appropriate solution.

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