Summary

Private retirement savings include both savings in individual retirement arrangements (personal pension plans) and employment-based (occupational) pension plans. Savings in these systems are subject to special tax-treatment. First of all, private pension savings are exempt from income taxation, implying that contributions are deducted from the income tax base. Income tax will instead be paid on the ensuing pension payments. Contributions to personal pension plans are limited to SEK 12 000 per year. When it comes to tax-exempt contributions to occupational pension plans, the ceiling is much higher: 35 percent of the wage income or a maximum of SEK 424 000 per year (2010).

Withdrawals from both kinds of pension savings are taxed the same way as wage income. The tax on return to pension savings is 15 percent. In this report, we identify three major problems concerning the taxation of private retirement savings.

1. Lack of uniformity compared to other forms of saving. Should retirement savings be favorably taxed, as compared to savings in general? This is a complicated question. Economic theory gives some reasons why retirement savings – to a certain extent – should be mandatory, as in public mandatory or occupational mandatory pension systems. But it is difficult to motivate a favorable tax treatment for voluntary pension schemes. It is sometimes argued that pension savings should be taxed differently due to the fact that they are restricted and a long-term saving – but that does not seem like a well-founded economic argument. Another possible motive for more lenient tax-treatment might be that the progressivity of income-taxation in Sweden is too accentuated and thus motivates tax reliefs for high-income earners. This is mainly a political argument and thus, it will not be dealt with in this report.

There is a theoretical rationale why the tax rate on savings should generally be kept low. But that is not a motive for tax reliefs for a particular savings vehicle. This is especially true if funds channeled through the pension sector are simply transformed from savings in other sectors (thus simply constituting tax arbitrage) and do not add to aggregate savings. To what extent pension funds represent additional savings, or just transformed savings from other sectors, is an interesting topic for future research.

In this report, we show that the tax deferral per se does not constitute a tax favor. However, the low tax rate of 15 percent on the accrued return on pension savings is a preferential rate relative to the rate of 30 percent for other forms of savings. Occupational pensions are subjected to an additional tax relief: no social security taxes are levied on contributions to employment-based pensions. Instead, the employers pay a special wage tax ("särskild löneskatt"). This special treatment is favorable to high-income earners. This means that these income groups can benefit from so-called "income shifting", i.e. transforming wage income into pension savings.

2. Lack of transparency and simplicity. When it comes to what kind of savings and which groups in society are favored by the special tax treatment for private retirement savings, our analysis illustrates the difficulty of penetrating these effects. The reason for this is that the tax incentive is determined by three parameters: the ceiling on the income deduction for contributions, the level of capital income tax on accrued returns and the special wage tax, levied on contributions for occupational pensions. The interaction of these three parameters is a complex matter. What total level of taxation you can expect will, in turn, be determined by future marginal income tax rates, the level of the total pension benefits, whether you are above or below the threshold for the additional income tax levied by the central government, as well as the future tax system as a whole.

3. International tax avoidance. The mobility of capital within the EU is a potential problem when it comes to taxing pensions. Since contributions to private retirement savings are exempt from income taxation, and the ensuing pension payments are subject to taxation, this deferral can be seen as a tax credit. But if the pensioner settles abroad – which will probably be a common situation in the future – it is not evident that the Swedish tax authority will be able to fully tax the pension benefits. Similarly, taxing the accrued returns on investments in pension savings plans will probably be difficult, especially if the pension fund manager is located outside Sweden. When it comes to Swedish tax bases, the internationalization of the capital market has resulted in a higher risk for tax avoidance, both concerning the tax credit for pension savings and the capital income tax on accrued returns.

In principle, these three problems can be dealt with, and solved, separately – but they can also be taken care of with a more comprehensive approach. Our proposal for a comprehensive reform can be summarized as follows: *Make pension insurance subject to the same tax treatment as so-called capital insurance*. This implies taxing the contributions and exempting the pensions, here referred to as "regular taxation" as opposed to deferred taxation. The same set of rules should apply to both personal retirement savings and occupational pensions. Contributions to occupational pensions will thus be made out of taxed earnings, and the pension benefits will consequently be tax exempt. The part of the wage used for pension savings will thus be levied with social security contributions. This means that the special wage tax will automatically be abolished, together with its little known of and opaque redistributional effects, mainly favorable to high-income earners.

The capital income tax on accrued returns to pension savings is the parameter that is most easily adjusted. We have been carrying out calculations concerning the effects of different tax rates – for example the rate of 27 percent at which capital insurance is taxed today. Even after such a sharp raise of the tax rate, pension savings are still taxed under a preferential regime, compared to other saving vehicles, although of course less preferential than before.

The problem with future international tax avoidance could be partly neutralized with a system of regular taxation, since it will lead to a situation without any tax deferral or tax credits. Further, the whole tax system in this area would be more transparent and foreseeable and the distributional effects of the tax regime for private pensions savings easier to analyze.

The capital income tax from returns on investment in private savings could still be changed, without abolishing today's deductibility or the special wage tax. Correspondingly, a system of regular taxation could be introduced without changing the tax on returns or the special wage tax. Finally the special wage tax could be transformed into a normal social-security tax without adopting a system of regular taxation and without changing the tax on returns. However, if we taxed pension savings in the same way as capital insurance, we would have a comprehensive solution which would create a more simple, equitable and transparent system for the taxation of Swedish private pension savings.