

# Taxes on earned income, other income and pension wealth – some efficiency and equity issues in an intergenerational perspective

Anders Kristoffersson

Swedish Ministry of Finance

ITD Global Conference on "Tax and Inequality, India  
2011

## Some basic features for Sweden

- a high-tax country (Tax/GDP  $\approx$  45 per cent)
- a high income country (NNI per head  $\approx$  35 000 US \$)
- a small open economy
- a favourable budget position – surplus goal of 1 per cent of GDP achieved for a number of years
- a reformed public pension system (1990's)
- a three pillar pension system, but dominated by public and occupational systems
- a yield tax on pension capital (pillar 2-3) introduced in 1991
- a broad-ranged EITC (2 per cent of GDP) introduced in 2007

# Pension systems matters too

- pay-as-you-go vs funded systems important issue but
- benefit-based vs contribution-based systems equally important
- public pensions reformed in 1990's
  - contribution-base => income-base within a PAYG system (pension rights 16 per cent of life-time earned income (cap on pension rights)) – efficiency
  - outgoing pensions conditioned on general income growth (~ real income growth) – the 'break'
  - a small funded part (2.5 per cent of life-time earned income (capped))
  - supplement: Basic pension – equity

# Taxes, pensions and the incentives to work, retire and save

- **Taxes and employment** (OECD(2011)) presents measures of FIR (financial incentives to retire), affected by taxes on
  - labour income
  - pension wealth and
  - pensions
- effects on
  - labour supply
  - savings (and growth?)
  - on equity

# Taxes and labour supply (and demand)

- demographic challenge: Higher labour supply => higher sustainable employment
- an EITC (2007, expanded 2008-2010) => lower extensive margin (above all) but also lower intensive margin
- some tax reliefs for pension income (2008 financial crises) but growing gap between taxes on 'passive' and 'active' generations an important political economy issue – efficiency vs equity!
- lower SSC's on youth and elderly => higher labour demand – relative age-dependent elasticities, wage compression, new entrants

# Taxes on pension capital

- for pillar 2 and pillar 3 pensions, ETT systems (income tax), compared to most others with EET systems (expenditure tax).
- if pillar 2 and pillar 3 mainly affects high income earners => a yield tax ('middle T') improves equity
- countries' choice affected by relative importance of pillar 1 vs pillar 2-3?
- in spite of ETT, wages/salaries could be tax discriminated compared to pension contributions => early retirement preferred to continued employment
- political economy matters (important stakeholders)

# Taxes, savings, labour supply and investments – different positions

- position 1: Taxes  $> 0$  on savings hampers real investments and economic growth and makes future generations poorer
- position 2: With a low interest rate (after tax) elasticity, a limited effect on growth and on future generations
- position 2 expanded: Reduce distortions by taxing different savings vehicles more uniformly and use revenues to promote
  - labour supply (e.g. EITC)
  - and real investments (and growth) by lower CIT (especially for small open economies)

## A concluding "check-list"

- The 'optimal' generational tax structure for one's country depends on
  - the design of the pension system (PAYG/fund, benefit/contribution, relative importance pillar 1-3)
  - the degree of inequality of income before taxes (income dispersion among 'actives')
  - demographics ('active'/'passive' ratio, economic 'facts' and political economy issue)
  - the size and degree of openness of the economy