# *Tax Treatment of Public and Private Pensions*
## *Zdanění veřejných a soukromých penzí*

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### Abstract
Different approaches to taxing public pensions and to social security contributions can be explained by differences in emphasis on various social models in different countries and by inconsistencies in the implementation of social and fiscal reforms. The concept of funding of public health care is of essential importance as well. Occupational schemes acquired after the Second World War a significant role in pension systems and have become their second most important pillar. In a number of countries they have this status till today, despite modern pension theory tends to replace them by personal pensions, but these usually have a much higher overhead costs. Tax theory is not uniform in approach to the taxation of personal pensions, in practice there is a considerable tendency to stimulate significant retirement savings and ignore the fiscal costs associated with it. EU tax policy rejects taxation of personal pensions and other financial services by VAT on the basis of alleged technical problem with the taxing of margin. Taxation and subsidization of pensions in Czechia requires a fundamental reform. The paper may be a background for such a reform.

### Keywords
public pensions, private pensions, occupational schemes, personal pensions, personal income tax, social security contributions, value added tax, social models

### Abstrakt
Rozdílné přístupy ke zdanění veřejných penzí a k příspěvkům na sociální zabezpečení lze vysvětlit rozdíly v důrazu na různé sociální modely v jednotlivých zemích a také nedůsledností v provádění sociálních a daňových reforem. Podstatný význam hraje i koncepce financování veřejné zdravotní péče. Podnikové penze nabyly po druhé světové válce podstatnou roli v penzijních systémech a staly se jejich druhým nejvýznamnějším pilířem. V celé řadě zemí mají toto postavení dodnes, přestože moderní penzijní teorie má tendenci je nahradit osobními penzemi; ty ovšem obvykle mají podstatně vyšší režijní náklady. Daňová teorie není jednotná v přístupu ke zdanění osobních penzí, v praxi jsou nemalé tendence k výrazné stimulaci penzijních úspor a k ignorování fiskálních nákladů s tím spojených. Daňová politika EU odmítá zdanění osobních penzí a dalších finančních služeb DPH na základě údajného technického problému se zdaněním marže. Zdanění a dotování penzí v ČR vyžaduje zásadní reformu. Příspěvek má ambici být podkladem pro takovou reformu.

### Klíčová slova
veřejné penze, soukromé penze, podnikové penze, osobní penze, daň z příjmů fyzických osob, příspěvky na sociální zabezpečení, daň z přidané hodnoty, sociální modely

## Introduction

After the World War Two different pension systems emerged in the market economies, comprising public, occupational and personal pensions and pension savings. While most public social pension insurance systems resigned for the full or partial funding of these schemes for practical reasons in fifties, most occupational schemes maintained and developed the funding principle. In the latest two decades there were strong tendencies to privatize the earnings-related public pension schemes in Latin America and post-Communist countries, utilizing personal pensions of all types. In this varied pension world there are many contact points of the pensions to the personal income taxation, social security contributions and consumption taxation that influence the extent of use of the private (personal and occupational) pensions and thus the whole structure of the pension system in the respective countries. Several countries even utilize strong fiscal incentives for pension savings.

The aim of this paper is to review the parallel development of the tax theory and policy and of the pension theory and policy, concentrating on their intersections – on the tax and other fiscal treatment of different pension products under the different social models and systems. We mention also the EU policy in this area, which mainly affects the occupational schemes and indirectly also the area of value added tax – in taxation of financial services. In doing so, we will constantly pay attention to the current state of the problem in the Czech Republic and to the possible application of any comprehensive concept.

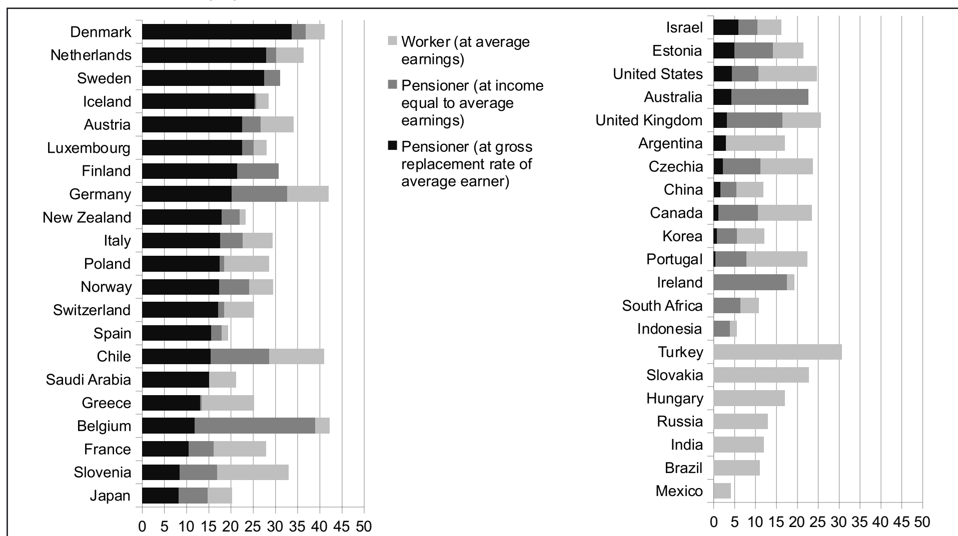
## 1 Taxation of Public Pensions

The OECD (2011) prepared an overview of tax treatment of pensions and pensioners. The key results are as follows: "The personal tax system plays an important role in old-age support. Pensioners often do not pay social security contributions. Personal income taxes are progressive and pension entitlements are usually lower than earnings before retirement, so the average tax rate on pension income is typically less than the tax rate on earned income. In addition, most income tax systems give preferential treatment either to pension incomes or to pensioners, by giving additional allowances or credits to older people" (p. 122). The extent of preferential treatment to pensioners compared to workers is shown by the OECD in Figure 1; the amount of the so-called full pensions is modelled here for workers with average earnings. Individual OECD and G20 member states are ranked based on the percentage of the model pension taxation, from the highest pension taxation rate in Denmark to zero taxation of the pensions in Mexico. Of the 42 countries in total, only 10 countries have zero taxation on pensions. Surprisingly, the Czech Republic is not included in this list of 10 countries in the Figure, in spite of the fact a pensioner would not pay any taxes in the standardized example (calculation of pension based on average nationwide earnings) according to the situation prevailing in 2008 (and to this date); according to the Figure in question, a pensioner would have to pay approximately 2% of pension.

The taxation of workers' average earnings, including the social security contributions, is shown as the total length of the column in the Figure, consisting of up to three sections. The average rate of this taxation of earnings in the OECD amounted to 26.4%, while

amounting to 12.8% in other G20 countries mentioned. The last section of the column for individual countries (the right section) shows the tax benefits of pensioners compared to workers. The hypothetical assumption here is that a pensioner has a pension of average nationwide earnings. The OECD average for the benefits should amount to 8.2% of gross earnings; therefore, an average OECD pensioner would pay an income tax and social security contributions at the total rate of 18.2% (difference of 26.4 and 8.2) on a pension amounting to average nationwide earnings. In relation to earnings, pensions are taxed considerably lower; the actual average taxation of the said model pensions in the OECD amounted to 11.8%. The difference of 18.2 and 11.8 thus illustrates the rate of preferential treatment of pensioners to workers in the area of taxation (OECD, 2011).

**Figure 1**: Personal income taxes and social security contributions paid by pensioners and workers (%)




*Source: OECD (2011)*

Figure 1 contains not only public pension schemes, but also mandatory and quasi-mandatory private schemes. The tax regime of the (quasi-)mandatory pension schemes should normatively be identical, whereas this is considered as implied within foreign literature. If we were to attempt a normative conclusion with the use of the said OECD data, the only option would be to require uniform taxation of earnings and pensions; this is implied in terms of tax theory – and only political reasons could lead to lower taxation on pensions in most OECD/G20 countries, with zero taxation on pensions in 10 of those countries. Theoreticians should emphatically call attention to the rationality behind the tax regime consolidation – i.e. to implement a system of uniform taxation of earnings and pensions. Germany has a program of this tax unification by 2040 (starting from 2005), based on the constitutional equality of people in this regard (BMF, 2009). A single-stage transformation, associated with a major reform of Czech public pensions, is feasible in the Czech Republic. This could technically be carried out by simply increasing the current pensions by the tax amount to be imposed on such pensions. For this reason alone, it would be useful to have a relatively stabilized income tax construction, namely in terms of taxation of the so-called

super-gross salary – and associated taxes identified as social security contributions or public health insurance premiums.

Social security contributions are, both in Figure 1 and in other international overviews, consolidated with personal income tax – they are simply considered as taxation of income. These contributions represent one of the tax pillars, one of the components of the "tax mix" and internationally defined tax quota. There are undeniable advantages to this as well. However, when analysing tax and social systems in more detail, we also have to ask a question whether the existence of the "social security contributions" is justified, namely in respect to pensioners in this regard: should old-age pension beneficiaries contribute to "their" (or other?) pensions or to the social security sector in the broad sense, including healthcare?

From the perspective of a model, it is possible to distinguish 3 or 4 basic pension schemes. Under a modern liberal model, old residents receive a universal (flat) pension from the state or an income-tested benefit (pension), which increases the residents' income to the specified minimum, amounting to, for example 27.7% of average male nationwide earnings in Australia (CA, 2009). From the perspective of their model, both old-age pension concepts are tax-financed – therefore, in principle, no pension insurance premiums exist here.

The situation is opposite under the conservative pension model: insurance premium is the only source of funding of the social pension insurance. The system may either be fully-funded (FF) or utilize pay-as-you-go financing (PAYG). In this case, the insurance premium is thus implied and, from the perspective of a model, it is not a "pension tax" (as this budget revenue is labelled in the Czech Republic), but rather a product price. The pension insurance premium is paid from earnings, according to recommendations of international experts, up to the limit of 125-200% of average nationwide earnings. Under the modern model version, newly awarded old-age pension is calculated from the insurance premiums paid, using actuarial mathematics. In this model, pensioners without any income do not pay pension insurance premiums; they have already paid them, so to speak. On the other hand, pensioners with an earning pay the insurance premiums; however, from their actual earnings, whereas any insurance premiums paid are reflected in an increase of their pensions.

The lack of the pension insurance premium payments on pensions does not mean that it is not possible to impose insurance premium in respect of another social security area under the conservative model. The reason for this is the fact that the social health (sickness) insurance represents a standard part of the conservative social model, whereas the insurance premium payments on the part of pensioners are systemically justified. (At the same time, this concept /alternative/ may also be reflected in the amount of the granted pensions.) This is the case in Germany – pensioners pay sickness insurance premiums on pensions (without the right to claim a sick pay; however, with the healthcare as a sickness insurance benefit), similarly as workers. The second half of the insurance premiums is paid by their pension insurance institution.

The social-democratic pension model also comprises the social pension insurance, which is uniform for all workers. (The social insurance is fragmented for individual social groups under the conservative model.) The insurance premium is uniform; therefore, basically the

same principles apply as under the conservative model. The practical difference consists in the insurance premium payers; the best option for the social-democratic model represents insurance premium payments by employers only – this is not entirely the case in Sweden, as employees pay 7% of their wages; however, the construction of the insurance premiums as a whole is surprisingly complicated in this country. Under the conservative social insurance model, insurance premium payments have been "divided" (into halves) between employees and employers due to ideological reasons – to ensure that both parties to an employment contract take part in the social insurance funding, since they both have an interest in its existence. "Yet, as a matter of legislative intent, this sharing provision was introduced to "divide" the burden." (Musgrave, 1989).

Neoliberal policy requires or recommends, as appropriate, insurance premium payments to be made solely by employees, to ensure that it is clear the social security contributions are part of the labour costs, i.e. it is nothing workers would get for free. Based on the transparency requirement, the super-gross salary concept came into existence in the Czech Republic; however, the respective government did not attempt to implement it in the end. Nevertheless, it introduced the super-gross salary concept in advance, as the basis for the calculation of personal income tax. From the perspective of general economic theory, there is no significant difference between insurance premium payments made by employees or employers; however, the combination of both payers is generally economically illogical. Moreover, the Czech practice, with both employees and employers being "premium" payers in an absolutely incidental proportion – based on the computation results "received" during the tax reform of 1993 – cannot be explained at all. And we have to add that the Czech public "pension insurance" is mainly a payroll tax (and not an insurance premium) due to prevailing solidarity redistribution. Taking it into account we may, more or less, only analyse the tax burden shifting, e.g. under different market conditions (Musgrave, 1989).

The communist system of detailed central planning did not allow any room – either factual or ideological – for social insurance. For this reason, the national insurance premiums, paid by employees were integrated in 1953 – into a "uniform" income tax in Czechoslovakia. Furthermore, the taxation of wages as such, or the taxation of population in general, opposes the communist ideology. Therefore, the policy comprising a transition to a "tax-free state" – meaning no taxes paid by the population, with no income tax as a priority – was later declared in the Soviet Union. The taxation of wages, let alone the taxation of pensions, does not make any sense under the communist model. The state directly controls wages – there is no need to complicate it by taxation. The state budget revenue is covered from the transfers of profits by state-owned companies and from a turnover tax, defined as the difference of the two price levels set down by the government (wholesale and retail prices). It was also indicated that the turnover tax is not a tax (either), but a form of net income generated in the course of production. Ideological clichés aside, we can see the simplicity of the communist model – it is unnecessary to tax not only pensions, but also wages. In the Czechoslovak practice, a "special pension income tax" was implemented in the 1960s, as the government was forced to cut pensions as a result of unsuccessful economic policy. The aforementioned tax was successfully discontinued after a prolonged period of time and, consequently, we inherited a system of zero-taxation on pensions under the Velvet Revolution. No major reform has taken place in this area yet, whereas

no government has started preparing it. The "only" measure taken by the government, as part of the economical fiscal packages, was the introduction of taxation of relatively high pensions, together with taxation on pensions drawn in concurrence to earnings, and annulment of the right of wage-earning pensioners to claim the basic tax credit.

Let us, once again, go back to the social-democratic model. The universal healthcare, financed from public budgets without the use of insurance premium, is part of the model. Consequently, no health insurance premium is paid on pensions under this model. This allows even higher personal income tax or another tax. On the other hand, the neoliberal model of universal healthcare funding foresees that all residents – including pensioners – pay a flat rate insurance premium, independent of their income or health. At the same time, poorer residents receive a social allowance to such insurance premium, scaled according to their respective income level.

Overall, it is common in OECD countries to have a significant personal income tax and, in terms of modern theory, it is also necessary to fully apply such tax to public pensions and (quasi-)mandatory private pensions. The collection of health insurance premiums on pensions or from pensioners, as appropriate, makes sense for segmented social health insurance and mandatory private health insurance, i.e. within conservative and neoliberal healthcare financing models.

## 2 Taxation of Occupational Pensions

Occupational schemes came into existence as an analogy to the pensions of public officials – individual undertakings started with a voluntary provision of pensions to selected employees, to express recognition of their work and, at the same time, to provide additional motivation for remaining within the company. In fact, it was a promise of pension payments in return for their loyalty to the company. Therefore, this conceptually represented a postponed payment of part of the wage for a later, relatively long period of time. The initial tax treatment concept also corresponds to this: occupational schemes are subject to full taxation, similarly as standard earnings, naturally at the moment the pension payment is made. The entire problem pertaining to taxation was exhausted in this manner within the model example; the pension was paid by the company using its operating funds, no reserves were created – because it was not necessary and, moreover, it would unnecessarily limit the business in using its company assets. Consequently, there were no contributions for pension fund creation, because the fund did not exist. In fact, it is a simple analogy to the pay-as-you-go financing of public pensions.

The initial accounting standard applicable to occupational schemes has been subject to significant changes, particularly after the Second World War. Occupational pension funds were commonly being formed and occupational schemes significantly gained in importance under many pension schemes, to a point where occupational pension security started to be viewed as the second pension pillar in the majority of developed countries, a supplement to the first, public pillar, often in the form of a social pension insurance – whether conservative or social-democratic type. Furthermore, occupational schemes typically ceased to have a loyalty feature, partially also due to the fact that the effort aimed at lifelong employment in one company no longer made sense. On the contrary, economies

started to develop dynamically, change structures, and all this required a flexible labour market that could not be held back by the concept of occupational schemes. Conversely, it was being underlined that occupational funds must be transferable – in case of a job change. International institutions made substantial effort aimed at allowing the transferability of pension entitlements between individual countries as well. It seemed that only the taxation of pensions remained from the original concept of occupational schemes. This means that the basis for the tax treatment has been the taxation of occupational pensions paid out, as a component of total incomes of individual person and/or families.

The new concept of occupational schemes brought about the formation of occupational pension funds, in the form of employers' contributions or a combination of contributions made by employers and employees. Unless this area of occupational schemes financing is regulated by government or superior collective agreements, the potential involvement of employees in the funding of their occupational schemes as well as the form of such involvement is always subject to an agreement at the company level. One way or another, the tax treatment of any contributions made under occupational schemes must also be regulated. At the same time, it was possible to apply a typical system of tax treatment of social pension insurance premiums, which consists in the exemption of insurance premiums paid under such pension insurance. Specifically, the model treatment of the social insurance premiums has been as follows: any insurance premium paid by an employee represents an item deductible from an employee's income tax base, whereas any insurance premium paid by an employer does not enter the employee's income tax base and represents the company's eligible cost item. The same elementary principle is also applied to occupational pensions.

The area relating to tax treatment of contributions to occupational or supra-occupational pension funds is more complicated than the area of tax treatment of social pension insurance premium. The reason for this is, as a minimum, the potentially substantially higher variability of rates and constructions of the occupational scheme contributions. While the social insurance schemes, including the insurance premium rates, are regulated by law and, as a result of their economic nature alone, there is basically no room for, e.g., the payment of higher insurance premiums, the typical situation for occupational schemes is just the opposite. Moreover, in case a tax deduction or tax eligibility of insurance premium costs represents /could represent/ motivation to increasing pension fund contributions, there is no wonder governments set down limits for deductions or eligibility of contributions.

Specifically, the following basic concepts (principles) of tax treatment for occupational schemes are currently used in the reference countries (Hughes, 2001):

- EET principle (Exempt contributions, Exempt investment income and capital gains of the pension institution, Taxed benefits) is used by the vast majority of EU member states, as well as the United States, Canada, Switzerland, Norway, and others;
- ETT principle (Exempt contributions, Taxed investment income and capital gains of the pension institution, Taxed benefits) is applied by three EU member states (Denmark, Italy, Sweden);
- TTE principle (Taxed contributions, Taxed investment income and capital gains of the pension institution, Exempt benefits) is used by New Zealand;
- TET principle is applied in Iceland and Japan.

The accurate categorization of individual countries according to individual principles for the occupational schemes taxation is complicated, simply for the reason that there are several types of occupational pension schemes existing in parallel (this is typical for Germany); moreover, international overviews of occupational schemes are not prepared very often and, last but not least, conceptual changes take place, e.g. to partial or full transition to a personal pension scheme, whereas employers are "degraded" to "mere" payers of contributions to pension funds of employee's choice. This also includes the salary conversion schemes (unknown in the Czech Republic), where an employee is entitled to ask his employer to convert part of his salary to a contribution to a pension fund of the employee's own choice – at least partially.

No occupational pension scheme effectively exists in the Czech Republic, although the EU forced us to formally implement the so-called Pension Directive (Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision /IORPs/). In the Czech Republic, the occupational pension scheme was already rejected by the Government of Václav Klaus at the beginning of the 1990s, for ideological reasons and due to concerns about frauds under prevailing insufficient infrastructure of government regulation of financial institutions. Liberals reject the existence of occupational pension funds, simply for the reason they are non-profit organizations, managed by the board, which is to act in the interest of clients. The main reason is the fact that individuals should make decisions regarding their pension security, not collectives or companies; otherwise these services are overused and result in inefficiency.

The objective of the Pension Directive of the EU was to develop the single market in the area of the pension funds, which operate under standard rules of comparable financial institutions – thereby contributing to the reduction of overhead costs. (Therefore, the Directive does not apply to, for example, the main German occupational pension scheme, under which companies only create book reserves.) According to the Directive, Pan-European pension funds were foreseen, e.g. at the level of large international groups of companies. The resulting effects of the Pension Directive are marginal – only about 85 Pan-European funds were established, though the IORP schemes cover about 25% of the working population of the EU (Chen, 2013). A revision of the Directive has been in the making for several years now. However, the problem may be more significant than the EU officials have admitted so far.

Together with the major change of the concept of voluntary occupational schemes, with employers degraded to payers of contributions to their employees' pension accounts, the key purpose/reason for existence of occupational schemes should be newly formulated. Personal pensions are capable of fully taking over their role, at least from the technical and legal perspectives. Only one potential reason remains for the existence of occupational schemes: the potential advantage of occupational schemes, compared to personal pensions, consists in the costs: the occupational schemes are – ceteris paribus – associated with substantially lower overhead costs, as there are no selling and similar costs as well as no profit margin. In addition to corresponding governance, it is also necessary to aggregate the relevant pension funds at an industry or nationwide level, e.g. according to the Dutch or Swedish example, to capitalize on the potential benefits of occupational

schemes. If this is the case, we will arrive at a system, which is closer or basically equal to segmented social pension insurance.

A different, opposite, approach was taken in Australia: In 1992, mandatory occupational pension savings were introduced, with an employers' contribution of 3% of wages. At the same time a schedule for increasing this rate up to 9% was declared. In 2005, a major reform took place consisting in the fact that most employees gained the right to select either a pension fund or a retirement savings account, i.e. products offered by banks, life insurance companies, and other financial institutions. A transformation of occupational pensions to personal pensions thus basically took place; to be accurate, we should refer to it as to occupational or personal retirement savings, because it is not required to purchase annuity for the savings in Australia – and only about 10% of clients purchase it in practice. To my surprise, the reform led to an increase in the number of the providers of such products – amounting to 427,000 in March of 2010. We shall see how the situation develops further; so far, the contribution rates have been gradually increasing, up to the new level of 12% in 2019/2020. Apparently, people in Australia are happy with the mandatory pension savings scheme, with an exclusive contribution of an employer (however, employees may also "add" their own funds). The Australians have also recommended the system to the British, who continue in the implementation of the "soft compulsion" scheme on the basis of an automatic enrolment and, in the interest of reducing the very high costs of the private sector, they even established a low-cost state-owned pension company NEST Corporation, which is to offer the administration/management of pension funds to companies, particularly for poorer employees, who cannot afford the high overhead of the private financial sector.

Let us, once again, go back to the taxation systems, such as EET, TTE, etc. So far, we have concluded by stating the EET principle is usually applied to occupational schemes, consistently with the typical tax treatment for the social pension insurance. Let us put a question, how this stands in compliance with the concepts of tax theory and policy. For illustration, we will use simple examples created by Whitehouse (2005) – see Table 1. It looks at a contribution of 100 made 5 years before retirement, with a proportional tax of 25% and annual returns of 10% a year. The first column shows the EET system, income for the given rate amounts to 61, the final fund then amounts to 161, of which 40 is allocated to taxes and the amount of 121 represents the resulting net pension. The second column represents the TEE system, with only the contribution subject to taxation; the resulting net pension is the same as in case of the EET system. The following two columns illustrate the TTE and ETT systems, with "double" taxation, whereas the resulting net pension is lower than in case of the EET and TEE systems. The question is: Which of the two pairs of pension taxation is the "right one"? Dealers only find the EET system to be suitable of the four options, because they are able to easily demonstrate the great effect resulting from the deferred income tax; in doing so, they somehow "forget" the final taxation itself. Consequently, they actually demonstrate the effects of compound interest – which is not really obvious in Table 1, as the funds bear interest for the period of 5 years only.

**Table 1:** Possible pensions´ tax regimes

| | EET | TEE | TTE | ETT |
|---|---|---|---|---|
| Contribution | 100 | 100 | 100 | 100 |
| Tax | - | -25 | -25 | - |
| Fund | 100 | 75 | 75 | 100 |
| Returns | 61 | 46 | 33 | 44 |
| Final fund | 161 | 121 | 108 | 144 |
| Tax | -40 | - | - | -36 |
| Net pension | 121 | 121 | 108 | 108 |

*Source: Whitehouse (2005)*

We have derived the logic of the EET system for occupational schemes from the interpretation of pension as a deferred wage. However, is it an income tax logic? A pension represents an income – and if we stem from an assumption that the government wishes to tax the residents' income in the form of a personal income tax, the taxation of pensions is all right. The issue is, however, the approach to not taxing the contributions to occupational schemes and to not taxing investment income of pension funds. The same problem also relates to the tax treatment of the social insurance premiums as well as the investment income in case of existing social pension insurance funds.

Income tax became the "queen of taxes" in the 20th century, as it had been considered as the "best" tax by Liberals even prior to that, whereas its rate should have been proportional not to modify the income relations. A progressive income tax became predominant in the practice of developed countries. The selection of the basic tax mix component is the matter of public choice, with lobbyists and theoreticians involved in such choice. Since the mid-20th century, Neo-Liberals strived to replace the taxation of income by taxing consumption in various forms. Friedman proposed a progressive spendings tax as the best source of revenue to meet critical national objectives in an article in 1943 (Frank, 2006). The strengthening role of a value added tax is also in line with this ideological movement. In this regard, we find the following relevant: it is also possible to enforce a consumption taxation concept by using deductibles for an income tax base. This form of a consumption tax tends to be referred to as an expenditure tax. The EET tax regime may be labelled as a "classical expenditure tax", with the TEE regime referred to as a pre-paid expenditure tax (Whitehouse, 2005). Whitehouse is not the only one to consider the expenditure tax as the most appropriate benchmark for taxing pensions, as this tax is neutral between consuming now and consuming in the future.

For example, the neoclassical economics refuses the exclusion of savings from the income taxation. „The major argument for replacing an income by a consumption tax is that savings would no longer be taxed. A consumption tax, its advocates assert, would tax consumption and not savings. The fact that this argument is generally advanced by free-market economists, in our day mainly by the supply-siders, strikes one immediately as rather peculiar. For individuals on the free market, after all, each decide their own allocation of income to consumption or to savings. This proportion of consumption to savings, as Austrian economics teaches us, is determined by each individual's rate of time preference, the degree by which he prefers present to future goods. For each person is

continually allocating his income between consumption now, as against saving to invest in goods that will bring an income in the future. And each person decides the allocation on the basis of his time preference. To say, therefore, that only consumption should be taxed and not savings is to challenge the voluntary preferences and choices of individuals on the free market, and to say that they are saving far too little and consuming too much, and therefore that taxes on savings should be removed and all the burdens placed on present as compared to future consumption. But to do that is to challenge free-market expressions of time preference, and to advocate government coercion to forcibly alter the expression of those preferences, so as to coerce a higher saving-to-consumption ratio than desired by free individuals." (Rothbard, 2012).

The TTE and ETT tax regimes are often referred to as two alternatives of a comprehensive income tax. If an income tax is to exist in a country, one of the aforementioned tax regimes must be the benchmark. It is possible to take into account potential weakness of income taxation in the course of implementation, e.g. a problem of taxing nominal interest and investment income or depreciation of savings as a result of inflation, as appropriate. The TTE tax regime means that pensions are not subject to taxation – and if we wish to tax pensions, we must opt for the ETT regime, currently applied by three member states of the EU. The TTE tax regime was fully implemented in New Zealand in 1990, as the implementation of the principle of "tax neutrality" of all savings vehicles. Occupational schemes in New Zealand may not receive any preferential treatment compared to other forms of savings, including the banking sector. It is a rigorous tax policy. We will return to New Zealand in another section of the paper.

The relation of the social insurance premiums and the contributions to occupational pension funds represents an associated issue. In case the social insurance premiums represent a deductible item for personal income tax base, the contributions to occupational schemes should be subject to the same tax regime.

The area of occupational schemes may be considered controversial in the sense that, after the Second World War, the development of these pensions resulted in the creation of a fundamental, second pension pillar, with a significant role of non-profit occupational pension funds. On the other hand, there is a trend regarding the transferability of pension entitlements as well as the transformation of occupational schemes to funded systems, managed according to the same principles as in case of private financial institutions; this trend ultimately leads to the replacement of occupational schemes by employers' contributions to personal pensions. The factual nonexistence of occupational schemes in the Czech Republic is a plus in this regard. Investment income and overhead costs of pension companies will be crucial moving forward. The results of the entire sector are significantly affected by tax policy, specifically by the tax regime selection for public pensions, occupational pensions, and personal pensions. The ETT and TTE tax regimes correspond to the comprehensive income tax concept.

## 3 Taxation of Personal Pensions

The taxation of personal pensions is, from a systemic point of view, mainly the derivation of the taxation of income generated from financial products, i.e. interest, investment in-

come, etc. It is also possible to express it by stating that an income is a nonrecurring and recurring payment, received from a financial institution, with possible deduction of costs of acquisition of the relevant product. Therefore, in case of a simple termination of pension savings, all savings contributions are deducted from the one-off benefit. In case the contributions were subject to an income tax, it represents the TTE tax regime, i.e. competitively neutral comprehensive income taxation. The ETT tax regime represents alternative model income taxation; however, it is difficult to implement if clients make contributions that had already been subject to income taxation. For the purpose of these model deliberations, we have left aside the consequences of any changes to income taxation in the course of pension or other savings.

When taxing personal pensions paid out throughout the insured's life (lifelong annuities), it is necessary to take into account the expected term of the annuity payments according to mortality tables under the TTE regime, whereas the theoretical taxation construction is thus approximated here. According to the Czech Act on Income Taxes, the tax base for the private pension insurance – i.e. consideration in the form of an agreed pension – is the pension derived from such insurance, reduced by "any insurance premium paid, evenly distributed to the period of drawing on the pension. In case the period of drawing on the pension is not defined, it is set down as the life expectancy of a participant according to the mortality tables of the Czech Statistical Office at the time he/she draws on the pension for the first time" (Section 8(7) of the Act).

The application of the income taxation theory to personal pensions is thus relatively simple. The TTE tax regime results in even taxation of personal pensions – in relation to the taxation of savings products as a whole, in the application of the same regime. However, the reality in the world is quite different – as characterized by Table 2. The categorization of individual countries must be "taken with a pinch of salt": input data are likely to be older than 10 years; moreover, it concerns all funded pensions (i.e. not just personal pensions), and, furthermore, several parallel systems exist in a number of countries.

**Table 2**: Pensions´ taxation in practice

| better than expenditure tax | expenditure tax | | between expenditure and comprehensive income tax | worse than comprehensive income tax |
|---|---|---|---|---|
| Australia | Argentina | Netherlands | Denmark | Belgium |
| Austria | Canada | Poland | Finland | Iceland |
| Czech Republic | Chile | Spain | France | Japan |
| Hungary | Colombia | Switzerland | Norway | New Zealand |
| Ireland | Costa Rica | United States | Sweden | |
| Korea | Germany | Uruguay | | |
| Portugal | Luxembourg | | | |
| United Kingdom | | | | |

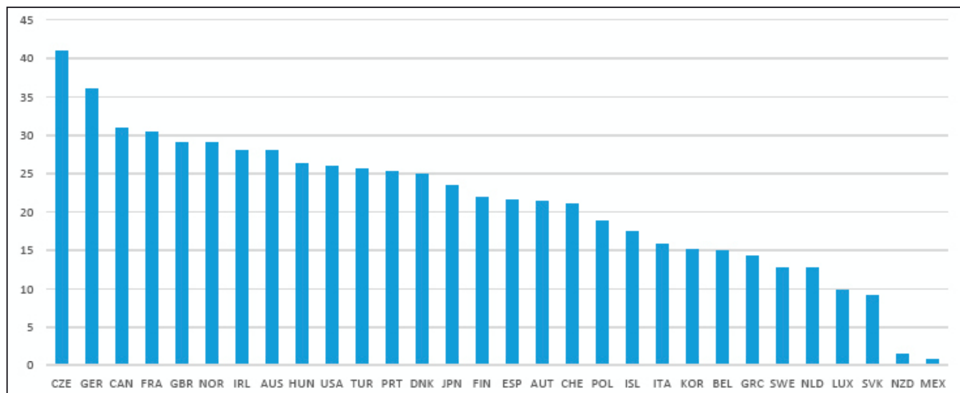
*Source: Whitehouse (2005)*

According to Table 2, a worse regime than the comprehensive income tax is applied in four countries, whereas five countries apply something in between such regime and the expenditure tax regime. Thirteen states apply the taxation of funded pensions in the sense of expenditure tax, while eight countries have even more beneficial regime than the expenditure tax; the latter group also includes the Czech Republic. The author of the figure states the following: "The expenditure tax is the most appropriate benchmark for taxing pensions. The comprehensive income tax treats savings as if they are like any other good or service. But savings are a means to future consumption, and this is particularly obvious when savings are deferred to provide retirement income. The expenditure tax is neutral between consuming now and consuming in the future." (Whitehouse, 2005, p. 2). This is a typical, purposeful argumentation, as the previous analysis shows. Funded pensions are declared to be exceptional products – and, therefore, standard income tax is not to be applied to them. Obviously, such arguments are positively received by pension companies that provide personal pensions or mere retirement savings without lifelong annuities or the combination of both, as appropriate – in the given country, based on local legislation. In terms of economics, it is a neoliberal deformation of the entire pension system. Tax or other benefits represent the major argument for acquiring personal pensions. However, tax expenditure and direct state contributions are not free – that is only the fiscal illusion. Someone has to cover their costs, e.g. in the form of a higher personal income tax rate. In case all people acquire a very profitable personal pension product (this is an ideal situation, since it is profitable), we will actually pay the costs of the state support of personal pensions to ourselves.

The Czech system of state support of supplementary pension insurance and the so-called private life insurance is not really standard. The state contribution to supplementary pension insurance came into existence with the introduction of the product, offered exclusively by "pension funds" – in fact specialized life insurance companies; however, without the standard license for the provision of life insurance, as currently required in the EU. The state contribution to the "supplementary pension insurance" had a specific construction, as the absolute amount of the contribution ranged from CZK 50 to CZK 150 a month (participant's contribution of CZK 100 to CZK 500 per month); however, the relative amount declined – from 50% to 30% of the participant's contribution. Furthermore, the pension lobby put a tax support through as of 1999, in the form of a deductible item from the participant's income tax base, provided he/she saves more than CZK 500 a month (or CZK 6,000 a year, as appropriate); it is possible to deduct up to CZK 12,000 a year. A year later, a parallel analogical tax support was enacted for the so-called private life insurance, offered by life insurance companies, applicable to insurance premiums of up to CZK 12,000 a year. As of 2008, a state support was introduced in the Czech Republic – without any special publicity – for the employers' contributions to employees' supplementary pension insurance and private life insurance; this support consists in the tax deductions of contributions of up to the total of CZK 24,000 per year for both types of products. The deductions also apply to the assessment base for the social security contributions. As of 2013, the annual limit was increased to CZK 30,000 (from CZK 24,000). In any case, this is systemically illogical – as both of the aforementioned products receive the same benefits in terms of the tax and fiscal treatment, provided the contribution is paid by an employer; on the other hand, the supplementary pension insurance receives substantially higher benefits than the "private life insurance" – as for contributions paid by participants.

According to the 2006 international comparison of the OECD, the relative amount of the state contribution to the supplementary pension insurance in the Czech Republic was the highest in the world – see Figure 2. The later introduced state support of employers' contributions to the supplementary pension insurance/private life insurance is even higher – amounting to 95% of the notional equivalent of the employee's contribution (it expresses the preference of the contribution to the wage payment). The state support was introduced without any prior effectiveness analysis. Moreover, no follow-up analyses have taken place either. Besides, the three forms of state support have no mutual logical links: the supplementary pension insurance and the private life insurance actually compete in case of the employer's contribution, as only one joint limit applies. With regard to the tax support of the participant's contributions, the supplementary pension insurance has a specific limit, while the private life insurance, representing many different products with an endowment component, has a separate limit as a whole. No one is even trying to explain why the supplementary pension insurance receives significantly preferential treatment, by means of the state contribution, in relation to the private life insurance. The situation still remains, even after the execution of a major supplementary pension insurance reform, which excluded the guarantee of the nominal savings value and insurance elements of the products, thereby depreciating the product to an investment savings product. New products of new pension companies are commonly sold investment products (and not only by investment companies, but also by life insurance companies); only the construction of the state contribution is new. The state contribution to the existing supplementary pension insurance and to the newly constituted "supplementary pension savings" is currently provided at the amount of CZK 90-230 a month (participant's contribution of CZK 300-1,000 per month), i.e. the relative amount ranges from 30% to 23% of the participant's contribution. Consequently, only the participant's contributions exceeding CZK 12,000 per year are deducted from the income tax base.

**Figure 2**: Tax incentives for pension saving




*Source: Whitehouse (2006)*

In reality, the Czech supplementary pension insurance, supplementary pension savings, and similar products offered by life insurance companies do not even represent pension products – almost all the participants opt for a one-off settlement instead of a pension. To a large extent, this is partly natural, common behaviour of people and, moreover, the of-

fered pensions are relatively expensive, which already results from the entire management system of private insurance/pension companies. Retirement savings in pension funds and other financial institutions are associated with relatively high overhead costs, especially compared to the public pension system: the cost handicap amounts to 2-3% of assets, representing 40-60% of the insurance premiums when converted using an internationally recognized ratio of assets and contributions (insurance premiums). This amount also comprises higher costs of the private sector in respect of lifelong annuities. (The reported costs of Czech pension funds amount to 1.45% of assets.) In addition, if we consider the state support of some 23-95% of the contribution, we will arrive at a rather horrifying illustration of efficiency of the "supplementary pension insurance".

The hypertrophy of the Czech supplementary pension insurance is more than obvious and it is significantly aided by the state support. In terms of economic theory, the only principal solution is the discontinuation of any state support provided to the supplementary pension insurance/private life insurance. In part, it is not a significant social-political instrument and, in part, the state support results in substantial distortion of the relevant markets. These radical steps were taken in Slovakia: state support for the participant's contributions to pension savings was annulled as of 2011; the Minister of Finance even proposed the annulment of the state support for employer's contributions to pension savings; however, he did not succeed.

The entire pension system in New Zealand is very interesting. In the previous section, we mentioned the neutral tax regime TTE for occupational schemes. The main pillar is a liberal, flat old-age pension (NZ Superannuation, NZS), the relative amount of which is maintained between 65% and 72.5% of average full-time net earnings, after taxation (for couples). With regard to people living alone, the pension is 32% higher than one half of the couple's pension (OECD, 2011). This is the highest flat pension in the world. In 2007, a major modification of the pension policy in New Zealand took place, with the introduction of the KiwiSaver product. The product does not concern genuine personal pensions – the annuity market does not exist in New Zealand at all (St John, 2009). The product is a combination of pension savings (investments), savings for the acquisition of one's first house, whereas the product funds may also be utilized in case a client runs into serious financial problems (e.g. in case of an disease or disability). The savings combo-product KiwiSaver is described as an employment-based or work-based product; however, it is basically not an occupational scheme. Nevertheless, an employer is required to contribute to an employee, provided such employee takes part in the KiwiSaver scheme. Moreover, the employers are also required to provide their employees with technical assistance. An auto-enrolment system is applied, under which new employees of the given institution are enrolled automatically; however, they may apply for annulment from the start – after 2 weeks of contribution payments, but only for a relatively short period of the next 6 weeks. They may not exit the system otherwise. Systems of this kind are considered "soft-compulsion" systems; liberal advocates of these constructions appreciate the possibility not to participate in the system, usually underlining the social aspect – specific poor employees or citizens may not be able to afford the product. At the same time, KiwiSaver was in principle intended for the middle class. "The target group is implicitly middle-income earners, given that NZS provides an adequate replacement rate for low-income earner, while those in the upper three income

deciles typically have substantial retirement wealth." (Coleman, 2010). Poor old people are relatively well provided for by the flat pension in New Zealand.

Originally, the employer's contributions were optional, while the participant's contribution initially amounted to 4% of earnings, with the possible increase to 8%. Several amendments later, also affected by the economic crisis, a mandatory contribution of an employer was set down as of April 2013, amounting to 3% of earnings, whereas the minimum contribution of employees amounts to 3% of earnings as well. KiwiSaver is subject to the TTE tax regime, i.e. contributions are made using taxed funds. The state also provides substantial support: each person is given a kick-start payment of $1,000 and, in particular, the regular state contribution. The state originally matched the member contributions up to $20 per week in the form of a 100% tax credit. The tax credit for employee contributions was reduced from July 2012 to 50% up to a maximum equivalent to $10 per week. The reduction of the state contribution took place as a result of fiscal pressures; the product sales were extremely successful. There is no wonder – given the huge state subsidies and mandatory contributions of employers. The government originally expected 680 thousand members in mid-2014 (25% of the population at the age of 18-64 years); in reality, there were 2.1 million members as of March 2013, i.e. 64% of the population at the age of 18-64 years (Gaynor, 2013). In 2013, the market is being serviced by 14 providers offering 134 products. In any case, New Zealand replaced the Czech Republic as the leader in subsidizing personal pensions according to Figure 2. The principal quantitative problem is; however, that it does not concern (personal) pensions either in New Zealand or in the Czech Republic, but only pension savings.

On the other hand, the state-subsidized personal pensions in Germany and Austria represent true pensions; they comprise the obligation to convert the savings/investments into a lifelong pension – unless genuine old-age pension insurance is arranged right away. In Austria, it is also possible to agree on a contract for 10 years only; in case a client does not continue with the state-supported product (called "security for the future with a bonus"), one half of the state contribution is returned and the capital income is subject to taxation. The state contribution ("bonus") in Austria currently amounts to (mere!) 4.25% of the member contributions; it is in the form of a refundable tax credit provided to each resident, who is subject to Austrian taxes, without any limitations. Approximately 1.5 million contracts for the given product have been concluded in Austria. The product is likely to be the subject of the election campaign – trade unions and association of pensioners criticize the low benefits for clients, product differentiation with individual providers, as well as the high overhead amounting to 30% of contributions (Blecha, 2013). The cost handicap – compared to public pensions – is also present in the German product "Riester-Rente", which is specific by its fixed-amount state contributions – for the member as well as his/her children. In principle, the member contribution always amounts to 4% of earnings, whereas the state support reduces the factual absolute amount of the contribution, resulting in a significant support of low-income families of up to 92% of the total member contribution. On average, the state subsidies amount to 30-50%. This is also the reason why Germany ranked second in Figure 2, behind the Czech Republic.

The provision of high state contributions to personal pensions – in one form or another – is a typical phenomenon in the majority of developed countries. It results from the im-

pact of neoliberal theory and policy as well as the impact of the relevant lobby. In many countries, the extent of the state support of financial products exceeds the framework of a unilateral concept of expenditure tax. Several countries have proceeded to reduce the state support of personal pensions as part of the money saving fiscal packages. Practical experience with the systems and products corroborates rather high overhead costs of the private financial sector; they should not, in fact, be covered by state contributions to clients. This provides some room for government regulation of the pension companies' overhead; a major or even total unification of the product terms and conditions, which would eliminate the room for fabulations of financial intermediaries, could also help. For more general reasons, some countries banned the provision of commissions to financial advisors by the financial product providers. The cost problems are significantly concentrated within the annuity stage of personal pensions; the private sector does not stand a chance without effective major government regulation. Although the "solution" to this problem consisting in limiting personal pensions to mere pension investments (savings) leads to overhead savings, the resulting product is no longer a real pension, which totally undermines the meaningfulness of state support for such product.

The role of personal pensions is not to be the private security at any costs, from the perspective of clients and the government. State subsidies are not free; they must be fully integrated within the analyses of all financial products that seek such support. Personal pensions as well as other financial products (e.g. contractual savings systems for housing in the Czech Republic) must be beneficial for clients even without any state support. A system without state support refers to the TTE tax regime for personal schemes, without any exceptions – even for other financial products. This also applies to employers' contributions to financial products negotiated by employees.

## 4 Value Added Tax

One of the defects of the existing value added tax (VAT) system is the treatment of financial services, where such services are in principle exempt from the VAT. This also results in, among others, the inability to deduct the tax included in the price of products purchased by the relevant businesses. The different approach to financial services is explained by the financial services specifics. According to this approach, financial institutions may charge the following for their services: a) explicit fees and commissions; and b) implicit fees in the form of a margin.

The application of VAT to "explicit" fees and commissions is considered to be trouble-free, per se; it is possible to apply the basic VAT construction. However, according to the EU, a problem exists for margin-based financial services, which represent approximately 2/3 of all financial services. This very much complicates the introduction of the existing type of VAT in this regard (EC 2010). Margins themselves, e.g. interest differences, actually represent added value. But the elementary problem is, apparently, the margin "allocation" to the part pertaining to the transaction with suppliers (deposits) and with clients (loans). The basic problem of this approach is, however, the mere existence of this approach to financial services. The present VAT taxes (or does not tax) individual transactions, irrespectively of whether it concerns the sale of products representing real final consumption or the "mere" sale of financial services.

In case of margin-based financial services under the conditions of the existing general VAT construction, it is possible and downright useful and practical to abandon the model approach, according to which the relevant companies "live off" the margin, to replace it by a more realistic model for the provision of individual services, where banks separately provide loans and other individual services, including deposits. After all, this is the common practice.

The remuneration for loan services is in the form of interest and fees, whereas the current standard VAT may be imposed on both of the prices. After all, interest may be viewed as a fee for the loan provision. In case it is not a problem to tax a standard bank fee, the same must apply to a fee calculated in the form of interest. The fee calculation method is not relevant.

The approach to insurance services may be analogical. The principle of equal terms for all deposit and similar services implicates that all deposit/investment services must be excluded from life/nonlife insurance for the sole reason of the VAT taxation. Besides, this will also be necessary in the course of further intensifying regulation of the insurance sector under the Solvency program. The exclusion of deposit services is also desirable in terms of the transparency of insurance services; in practice, it will disclose and hopefully even suppress the provision of downright disadvantageous savings/investment products. The VAT will also be used to tax individual fees as well as risk insurance premiums, including fees, whereas revenue on investments will be subject to income taxation. All this is applicable in respect of private pensions as well.

The principal idea behind the previous VAT deliberations was to show the tax may also be applied in respect of private and even public pensions. There is no major reason against the application of general taxation on consumption in the area of pensions. The fact that financial services, and thereby also pensions, are not subject to VAT in the EU represents a one-sided advantage of financial services to the detriment of the entire economy and also to the detriment of the overall effectiveness of the economy. The failure to apply the VAT to pensions represents an indirect subsidizing of pensions, which is both economically and politically unjustifiable.

## Conclusions

Prior to our Velvet Revolution, communist countries were inclined to introduce a state without taxes (on population); however, the implementation of the idea was prevented by major economic problems of the system. Radical, paradigmatic reforms of the entire social system are not easy to implement under democratic conditions. Nevertheless, there are certain trends in the world towards the full inclusion of public pensions in the comprehensive income taxation and the reform of this type is also feasible in the Czech Republic.

There was a significant expansion of occupational schemes in a number of western countries in the post-war period, but – at the same time – those schemes underwent a major conceptual change, consisting in the gradual implementation of the requirement for transferability of retirement entitlements between companies and states or in their transformation to personal pensions, as appropriate. In this regard, it is actually beneficial that occupational schemes were not introduced in the Czech Republic – due to the liberal Government of Václav Klaus. These schemes may be replaced by employers' contributions

to the personal pension schemes; however, there is a risk of even significant increase in administrative costs. Therefore, many governments strive for an establishment of low-cost public pension institutions.

The growing importance of personal pensions stems not only from the influence of the relevant financial institutions, but also from the strong effect of neoliberal concepts on the structuring of entire pension systems. The elementary general problem of the market system of the provision of personal pensions is the level of overhead costs; the unification of pension products, associated with the provision of state support to even one private pension product, may partially help. The high neoliberal state support for personal pensions basically results in a situation, where such support in fact finances high overhead of the private sector. The government should not support products that do not comprise the provision of a lifelong annuity. The basic alternative to taxing personal pensions is the payment of contributions from taxed personal income as well as the taxation of investment revenue during the accumulation stage. The replacement of well-constructed and well-managed public pension schemes by considerably more costly personal pension schemes is economically inefficient. No pension system is ideal; however, it is always necessary to consider both the overhead and fiscal costs.

The social security contributions represent an important part of the public revenue and they are also reflected in the pension taxation concepts. Under a modern liberal pension system, they are redundant, unsystematic. Moreover, the construction of the "pension tax" type, which exists in the Czech Republic, among others, is also unsystematic, as the collected insurance premiums are redistributed, to an extreme extent, among the system participants. In this regard, the theory recommends the system partition – to, for example, a tax-financed flat pension and fully equivalent insurance pension, financed via insurance premiums, deductible from an income tax base.

The exemption of financial services from the value added tax in the EU relies on the false technical arguments and may be perceived as a result of lobbying of the financial sector. The reason for this consists in the fact that the current VAT is applied to the sale of products; however, not to the margins of financial institutions. The VAT is replaced by separate taxation of selected financial products in most western countries; however, this results in market distortions. A radical VAT reform is possible. The failure to apply the VAT to pensions represents an unjustified state support.

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