Policy guidelines for improving the design of financial incentives to promote savings for retirement

All countries provide financial incentives to promote savings for retirement in the form of tax incentives or non-tax incentives (matching contributions or fixed nominal subsidies). These incentives provide an overall tax advantage to individuals by reducing the amount of personal income tax they have to pay when saving in private pension arrangements as opposed to other savings vehicles. This tax advantage entails a fiscal cost. Governments therefore need to make sure those incentives are an effective tool for promoting savings for retirement. *Financial Incentives and Retirement Savings* provides guidelines to improve the design of financial incentives.

Financial incentives are a useful tool for promoting savings for retirement

Financial incentives are effective at increasing retirement savings and help individuals to diversify their sources of retirement income financing. While they usually result in lower participation levels than compulsory and automatic enrolment schemes, they enable individuals to choose and take responsibility for their own retirement planning.

Tax rules should be straightforward, stable and common to all retirement savings plans in the country

Complex tax incentive structures may reduce the impact of tax incentives on retirement savings. Frequent changes to tax rules risk reducing trust in the pension system and prevent individuals from adequately planning ahead.

The design of tax and non-tax incentives for retirement savings should at least make all income groups neutral between consuming and saving

Tax neutrality means that individuals experience no difference between consuming and saving. At the very least, the tax treatment of retirement savings should not discourage savings. It may even be justified to introduce greater incentives for savings amongst certain groups of individuals, in breach of tax neutrality. Interactions with the public pension system and the general tax system should also be carefully analysed. People will refrain from saving for retirement if doing so reduces their entitlement to a public pension or another form of tax relief.

Countries with "EET" tax regimes already in place should maintain the structure of deferred taxation

The upfront costs of introducing a pension system with deferred taxation have already been incurred in most countries. The reward, in the form of collecting increased taxes on pension income, will come in the future as these systems mature. The short-term and long-term impacts on fiscal costs should be considered before modifying an "EET" tax regime.

Countries should consider the fiscal space and demographic trends before introducing a new retirement savings system with financial incentives

The maturity of pension systems and demographics influence the fiscal cost of financial incentives. The fiscal cost also develops differently depending on the tax regime chosen, with, for example, a larger upfront cost in the case of the "EET" tax regime.

Identifying the retirement savings needs and capabilities of different population groups could help to improve the design of financial incentives

Individuals may differ on how much they need to save into complementary funded pension arrangements, particularly when a public pension system delivers different replacement rates to different income groups. Financial incentives may need to be higher for those with higher savings needs.

Specific financial incentives for individuals whose income is below or around the poverty line may not be necessary as they cannot afford to save in voluntary supplementary pension schemes and will rely on the safety net at retirement age.

Tax credits, fixed-rate tax deductions or matching contributions may be used when an equivalent tax advantage across income groups is desirable

In some countries, policy makers may consider that a majority of individuals should get an equivalent overall tax advantage because savings needs are similar across the population. Financial incentives that equalise the tax relief provided on contributions for all individuals, independent of their income level and marginal income tax rate, achieve a smoother distribution of the overall tax advantage across the income distribution. They include tax credits and fixed-rate deductions (as opposed to deductions at the marginal tax rate of an individual), as well as matching contributions. These approaches increase the attractiveness of saving for retirement for middle to low-income groups, while reducing it for high-income earners, compared to the widespread "EET" tax regime. The decreased tax advantage for high-income earners may reduce, however, their incentive to save.

Non-tax incentives and fixed nominal subsidies in particular may be used when low-income earners save too little

Non-tax incentives are a better tool for encouraging retirement savings among low-income earners who are typically less sensitive to tax incentives. Fixed nominal subsidies, in particular, are likely to be more attractive because they are easier to understand than tax incentives and their value is not limited by the tax liability of an individual. Non-tax incentives can also target specific groups, such as young workers or women.

Tax credits could be made refundable and converted into non-tax incentives

Individuals with a low tax liability can still achieve the full benefit from tax credits when they are refundable, increasing the attractiveness of saving for retirement for low-income earners. The value of the credit is strengthened when it is paid directly into a pension account (converting the tax credit into a non-tax incentive), in order to help individuals to build larger pots to finance retirement.

Countries where pension benefits and withdrawals are tax exempt may consider restricting the choice of the post-retirement product when granting financial incentives

Early withdrawals and lump sum payments may be inconsistent with granting financial incentives to promote savings for retirement. Taxing pension benefits discourages early withdrawals and lump sum payments when the amounts received are added to the individuals' earnings and taxed at a marginal rate. If however withdrawals are tax exempt there is no financial disincentive for withdrawing early or taking a lump sum. Financial incentives may lose, therefore, their purpose if the policy objective when granting them was to encourage people to complement their public pension. To counter this, policy makers could restrict the choice of when and how to withdraw the money; take back part or all of the financial incentives when individuals take a lump sum or withdraw early; or promote selected post-retirement products that are more in line with the objective of people having a retirement income.

Tax-deductibility ceilings and the value of non-tax incentives need to be regularly updated to maintain the attractiveness of saving for retirement

Tax-deductibility ceilings for contributions tend to be updated each year in line with price inflation, if at all. When wages grow faster than inflation, more individuals are likely to reach the contribution ceiling and reduce their contributions to retirement plans. Over time, this will weaken the capacity of savings programmes to replace income. Similarly, keeping the same value of non-tax incentives (maximum matching contribution, subsidy) over time may reduce the attractiveness of saving for retirement and lower the positive impact on participation.