TAX REGIME FOR NPS:

Is it generous enough to encourage Retirement savings?

Pension reforms have been an issue of debate, on the effectiveness and adequacy front for several years now. With the proposed move towards EET, as per the Direct tax Code, would it impact the savings for retirement?

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Pension reforms is an issue of political economy and several critical problems to be addressed by the policy makers. One such problem is the tax treatment of retirement savings of funded pension. Therefore, it is a difficult task for authorities to achieve all these objectives in any economy characterized by heterogeneity in income distribution, wide variation in individual psychology of savings etc. Pension tax also needs to be considered keeping in view the maximization of retirement consumption, especially when work income either diminishes or becomes zero and a person has to depend on the financial income saved during the working life. Consumption maximizing objectives, however, relate to Life Cycle savings and consumption. The taxes must facilitate to strengthen savings motive and be able to transfer current financial assets for future consumption.

Life Cycle Savings and Consumption:

The very purpose of Retirement savings is to ensure the post retirement consumption, possibly at the pre retirement level by deferring the current consumption. Life Cycle, therefore, plays a very important role in consumption and saving decision of an individual. Normally a life cycle is broken into three phases namely youth, middle age and retired life. Consumption of an individual depends on the income and borrowing capacity. An individual can consume entire income or consume a portion of income and save the remaining amount. However, there is a tendency of consuming more in youth and saving less for future. But in the middle age savings tend to be higher, when consumption demand tends to be lower. The longer the period of savings, higher is the amount of accumulated financial assets which can be transferred for post retirement consumption. The investor may also consider future increases in income and increases in tax exempt contribution limit. Life cycle analysis thus throws important light on taxing pension funds.

Expenditure Tax:

Since Life Cycle focuses on the consumption and saving of an individual within budget constraints, any system of taxation which takes care of these two aspects of retirement savings may be ideally a good system. Composite income tax, which focuses on the income only, may not be suitable for taxing retirement savings, but Expenditure tax which focuses on Consumption expenditure of an individual will be able to deliver the twin objectives of encouragement to pension savings and generation of long term revenues for the Government. The expenditure tax is consumption neutral, since it does not matter to an individual whether she paystaxes now or at a later stage. Therefore taxing the current or future consumption does not have significant adverse impact on the consumption decision of the investors.

Forms of Taxes on Pension Savings:

Though a tax system close to expenditure tax is considered to be the best form of tax for taxing pensions, selection of an appropriate form is important since there are quite few formats of expenditure tax. While some countries prefer to tax pension savings at the end of accumulation period, some may tax such savings at the contribution stage, while others may exempt contribution but tax the investment return and final accumulation. Most of the countries impose expenditure only once – either at the time of contribution or at the time of pension payments. There are four major types of taxation close to expenditure tax that can be imposed on pension savings.

- **Exempt Exempt Tax (EET):**
Under EET contributions and investment incomes are exempted from tax while accumulated payments are taxed.

- **Tax Exempt Exempt (TEE):**
Under TEE contributions are taxed but fund income and payments are tax exempt.

- **Tax Exempt Tax (TET):**
Under TET, contributions and pension payments are taxed but investment incomes are tax exempt.

- **Tax Tax Exempt (TTE):**
Under TTE contribution and returns from investment are taxed but pension payments are tax exempted.

- **Exempt Exempt Exempt (EEE):**
Under EEE, contribution, investment income and pension payments are tax exempted.

Global Practices:

Most of the OECD countries including Austria, Germany, Netherlands, Sweden, Switzerland, UK, and USA etc introduced EET tax for funded pensions while New Zealand imposes TEE Tax on pension funds. Non OECD countries like Argentina, Chile, Columbia, Uruguay, Hungary, Poland and India etc impose EET tax while Peru imposes TEE tax on Pension funds. Countries like Japan, France, Iceland, impose TET tax. Though Pension tax in Australia is characterized as TET regime, contributions can be partly exempted (especially for low-income participants).Some countries, however, follow some other tax regimes e.g. Indonesia had introduced ETT while Philippines has introduced TTE tax for pension funds. Korea is a unique example which does not impose any tax on pension savings.

In Korea pension contributions, investment incomes and pension payments are tax exempt. Hungary, in order to attain distributional justice imposes lower tax rates for lower earnings while higher rates are imposed on higher earnings slabs. This helps lower income people to save more and to increase final consumption.

Tax incentives under the NPS in India:

NPS in India has adopted Exempt-Exempt- Tax (EET) regime, which has been adopted by a large number of countries globally. Under the EET, the contribution and investment returns of NPS will not be taxed but accumulation amount will be taxed. NPS also provided further incentives in the Union Budget 2009-10. Finance Minister has proposed to exempt the income of New Pension System Trust from the income tax and any dividend paid to this Trust from Dividend Distribution Tax (DDT). Similarly, all purchases sales of equity shares and derivatives by the NPS Trust will also be exempt from Securities Transaction Tax (STT) Securities.

Direct Tax Code:

Indian Finance minister released a new Income Tax Code in New Delhi on 12th Aug'09, which would lower the tax rates and would increase exemption limit. Currently savings, including pension savings, of Rs 1.0 Lac is exempted from the income tax but under the new tax code this limit has been extended upto Rs 3.0 Lacs. Reform will also reduce the rate of taxation. Under the propose system an individual having annual taxable income between Rs.160000/- and 1000000/- will be charged tax @ 10% while taxable income above Rs.1000000/- but up to Rs.2500000/- would be charged @20%. For income above Rs.2500000/- tax would be payable @30%. These measures will increase the ability to save more and will also boost up pension savings through NPS.

Does Tax system encourage Pension savings?

Probably the most controversial and contentious issue of taxation is whether generous tax incentives increases pension savings. Many experts often argued that EET tax system in NPS is discouraging the investors to save for retirement. But this argument seems to be untenable. EET does not have any discouraging impact on pension savings,neither even 100% exemption for pension savings only can boost up savings. What about EPS of EPFO or PPF, which provide full exemption? Further, Korea has introduced EEE tax but pension assets as % of GDP were only 3.1%, where as it was much higher in Peru (18.0%) which has adopted a TET system.

Pension assets as % of GDP in Chile, Columbia, Hungary, (with EET) were 64.4%. 14.3% and 10.9% respectively. Similarly most of the OECD countries have adopted EET tax regime but their pension assets in terms of GDP was very high. For example countries like, Netherlands, UK, USA adopted EET, and their pension assets was 132.2%, 86.3% and 74.3% respectively, whereas Pension Assets in Germany (which offers EET) was much lower (4.1) (See Table 1).

Table 1

Country	Taxation Type	Pension Assets as % GDP
Emerging Economies		
Argentina	EET	11.5
Chile	EET	64.4
Columbia	EET	14.3
Hungary	EET	10.9
Peru	TET	18.0
Indonesia	ETT	2.2
Philippines	TTE	N.A.
Korea	EEE	3.1
OECD Countries		
Netherlands	EET	132.2
UK	EET	86.3
USA	EET	74.3
Germany	EET	4.1
New Zealand	TEE	11.1
Japan	TET	20.0
France	TET	1.1
Australia	TET	105.4

Source: Whitehouse, Edward: "The Tax Treatment of Funded Pensions" Social Protection Discussion Paper Series, The World Bank, 1999
OECD: "Pension Market in Focus" December 2008, Issue 5

Therefore it can be assumed that generous tax incentives alone can not induce savings and particularly the retirement savings. Retirement savings are broadly influenced by target consumption after retirement, alternative sources of retirement income, bequest motives, current contribution limit for tax saving investment, saving & investment psychology of investors etc. Therefore, tax incentive is only a factor among many, which influences the motives of pension savings. The over all increase in pension savings will, however, depend on a combination of factors namely awareness & attitude of individual of retirement savings , Financial literacy, soundness & size of public pension system, Income dispersion & Age profile, liquidity constraints & Tax exemption limit, Level of capital market development & alternative savings opportunity , Quality of distribution & Fund management system etc.

In view of the above it can be concluded that tax regime for NPS in India is quite generous and provide enough incentives for retirement savings through NPS. What is needed is to understand the underlying benefits and bring it to the notice of investors. Stake holders in NPS including financial advisors need to have an objective and realistic assessment to provide the required guidance to the potential investors.

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