OECD Tax Policy Studies

Taxation of Household Savings

SUMMARY

No. 25

Executive summary

Following the 2008 financial and economic crisis, there has been renewed interest in the taxation of household savings as a means of strengthening the efficiency and fairness of countries' tax systems. Strong calls have come from civil society to increase capital taxation to address income and wealth inequality. Meanwhile, the recent move towards the automatic exchange of financial account information between tax administrations is likely to make it harder for taxpayers to evade tax by hiding income and wealth offshore.

This report provides a detailed and timely review of the taxation of household savings in OECD and five key partner countries in light of these and other developments. The report finds that, while countries do not necessarily need to tax savings more, there is significant scope to improve the way they tax savings. Most significantly, there are opportunities for countries to increase the neutrality of taxation across assets and thereby improve both the efficiency and fairness of their tax systems.

The lack of neutrality in the taxation of savings is illustrated by marginal effective tax rate (METR) modelling undertaken for 40 OECD and key partner countries across a range of potential savings options. METR modelling enables the impact of a wide range of taxes and tax design features to be incorporated into a single indicator. The results highlight significant variation in METRs across assets, with tax systems creating significant incentives to alter savings portfolio allocation away from that which would be optimal in the absence of taxation.

Private pension funds tend to be the most tax-favoured form of saving, with owner-occupied residential property also significantly tax-favoured. In contrast to owner-occupied residential property, rental property is often subject to relatively high METRs due to the application of progressive marginal personal income tax rates, capital gains taxes and property taxes. Bank accounts and corporate bonds also tend to be relatively heavily taxed in many countries.

Analysis of asset holding microdata shows that a move towards greater neutrality in the taxation of savings can often also improve the fairness of tax systems. Drawing on microdata for 18 European countries from the Eurosystem Household Finance and Consumption Survey (HFCS), the report finds that patterns of asset holdings vary significantly across both income and wealth distributions. Matching these asset holding patterns with METRs shows that current tax systems often favour the savings of households that are financially better-off. For example, poorer households tend to hold a significantly greater proportion of their wealth than richer households in bank accounts, which are typically highly-taxed, whereas richer households tend to hold a greater proportion of their wealth in investment funds, pension funds and shares, which are all often taxed relatively lightly.

While acknowledging the difficulty in achieving perfect neutrality across assets, the report discusses a number of ways in which countries can look to increase neutrality, such as through inflation indexation and consistent application of taxes across assets. A number of more fundamental reforms are also discussed, including exemption of the normal return on savings, imposition of an interest charge on deferred capital gains, and adoption of expenditure-based taxation.

The report also finds that opportunities may exist for some countries to increase progressivity in their taxation of capital income as a result of major changes to the international tax environment. The report argues that the recent move towards the automatic exchange of financial account information between tax administrations is likely to make it harder in years to come for taxpayers to evade tax by hiding income and wealth offshore – making it less distortive for countries to levy taxes on capital income. This may present a particular opportunity for countries that previously moved away from progressive taxation of capital income (due to concerns regarding such tax evasion) to reintroduce a degree of progressivity. The ability to implement such reforms and the degree to which progressivity should be increased will depend on a range of country-specific factors including existing levels of inequality and preferences for redistribution.

While the main conclusion of the report is the need for greater neutrality in the tax treatment of savings, there are exceptions. Encouraging retirement savings is the clearest example. Most countries encourage retirement savings by providing highly concessionary expenditure tax regimes for private pensions that often result in negative METRs. As societies in most OECD countries continue to age, and public pension systems come under increasing strain, there remains a case to maintain these concessionary tax regimes to encourage private savings. However, the tax treatment of voluntary private pension savings should be considered in a coordinated way with the financial advantages and generosity of public pension systems. For example, where public pension provision is substantial, there may be less need to incentivise the use of private pensions.

Finally, the report also highlights opportunities for equity-enhancing improvements in the design of taxes on household savings. For example, tax deductions provided for private pension contributions and mortgage interest payments could be turned into tax credits so that richer taxpayers do not benefit disproportionately from these concessions as compared to poorer taxpayers. Ideally tax credits would be refundable to ensure that taxpayers without sufficient tax liability in a particular year would still receive the full benefit of the tax credit.