Taxation of Pensions in Portugal: A Semi-Dual Income Tax System

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Introduction

The Portuguese personal tax reform in 1989 established a comprehensive, progressive and unitary personal income tax system. Since then, the system has evolved gradually towards a semi-dual income tax system with certain categories of income exempt from taxation and/or subject to flat nominal withholding tax rates as a result of a number of tax reforms. The semi-dual income tax combines a highly progressive tax schedule for labour and pension income with low and flat nominal tax rates on some forms of capital (personal and corporate) income. The departure from a comprehensive, progressive and symmetric income tax system is justified by arguments of international tax competition, capital mobility, economic efficiency, the special role of savings, equity, neutrality and risk-sharing considerations, pension system sustainability and adequacy issues, the need to increase saving for retirement, administrative simplification, growing fiscal constraints, high unemployment levels, the need to attract foreign direct investment, the challenges of European integration and globalisation, off-shoring and disintermediation, or simply difficulties in assessing taxpayers real income.

Despite numerous parametric reforms undertaken in recent decades, the latest as part of the "Troika" bailout programme, the Portuguese pension system continues to be dominated by a mandatory PAYG earnings-related defined benefit public scheme, comprising two separate, but convergent schemes, with voluntary occupational and personal funded scheme still playing a minor role in funding retirement income. Recent studies show that the systems continue to be unsustainable and will deliver inadequate income in retirement (Bravo, Afonso and Guerreiro 2013, 2014), unless a significant increase in the coverage and funding levels of private pension schemes takes place. The country was hit particularly hard by the economic and financial crisis and was compelled to cut pensions in payment and to reduce available incomes for older people through tax increases and temporary changes to the indexation of benefits. Tax relief for some retirement saving vehicles has either been capped by a given amount or simply eliminated. Some of the major occupational private pension schemes were incorporated into social security. This paper motivates and reviews the current semi-dual tax treatment of Portuguese pensions and other retirement income, highlights its particularities, and discusses whether it can contribute to the pension system's long-term goals and challenges.

A brief overview of the Portuguese pension system

The Portuguese pension system combines a dominant mandatory PAYG earnings-related defined benefit public scheme, comprising of two separate, but convergent schemes, with incipient voluntary occupational and personal funded schemes, and covers only 3.7 percent of the country's workforce. The funded pillars are privately managed and provide benefits based on individuals' contributions and investment returns. Additionally, the public system includes non-contributory, means-tested pension benefits and top-up minimum contributory benefits, fully funded by general taxes. Contributory pensions are financed on a PAYG basis by social contributions, paid both by the employer and employee, complemented by a small fraction of the VAT tax. Contributions to private schemes are elective, separate from the regular social contribution and made mostly by employers. There is a Social Security Reserve Trust Fund (FEFSS), which currently manages around EUR 14,000 million in assets, which is financed through a fraction of social contributions. Public (private) pension schemes grant old age, early retirement, disability and survivors (DC/DB) pension benefits. In 2014, total pension expenditure accounted for 15.7 percent of GDP and almost 75 percent of all social security expenditure. Average annual old-age pension amounts to EUR 5,098

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(16,111) for those in the private (public) sector. The current benefit ratio is 70.8 percent (54.9 percent) for male (female) pensioners, but is projected to decline significantly as a result of recent pension reforms and pension indexation rules. Occupational pension schemes grant benefits in the form of lump sum (maximum 1/3) and annuity payments. Although the saving rate is quite low (6.9 percent of disposable income in 2014), private pension saving schemes exist (e.g., in the form of individual acquisition of open pension units) and were very popular in the past due to generous tax incentives. In recent years Portugal has implemented numerous (temporary and permanent) parametric pension reforms (e.g., nominal benefit cuts, introduction of a sustainability factor, increase in the retirement age, new indexation mechanism) aiming to reduce public pension expenditure with little margin to address income adequacy concerns in an already very aged society. Policy (including fiscal) initiatives were driven by the short-term need for fiscal consolidation, rather than by a long-term prospect for the design of pension systems.

Taxation of pensions in Portugal

In this section we provide a concise analysis of the current tax treatment of pensions and retirement benefits in Portugal and how it compares in international terms. Before that, we briefly discuss the main alternative approaches to taxing pension income.

Basics of pension taxation regimes

The taxation of pensions involves three cash flows that can be taxed and the timing of taxation. Pensions can be (totally or partially) taxed (T) or exempt (E) at the point when employees and employers contribute or save to the pension scheme or savings vehicle, when asset returns (interest, capital gains or the equivalent gains in a PAYG system or distributable profit) arise, or when pension income is withdrawn. Given the three possible cash flows and timing points at which it is possible to charge taxes, a wide range of tax regimes can be found internationally. In a *pure* Schanz-Haig-Simons (SHS) *comprehensive income tax system*, all (or most) net cash income is added up and subjected to a common (usually) progressive tax schedule.[2] Accordingly, savings consisting of taxed earnings and accrual returns on accumulated funds are also subject to an income tax. In return, the withdrawal of assets from such saving vehicles is fully exempted from taxation. Such arrangements are known as TTE schemes. This method of taxation discriminates in favour of current consumption and acts as a disincentive to (particularly long-term) saving. In a *pure* Fisher-Kaldor-Meade (FKM) *expenditure tax regime*, only consumption is taxed. Accordingly, both funds contributed and investment income and capital gains accrued in the savings vehicle are exempted from taxation. In return, benefits are treated as taxable income upon withdrawals and, thus, taxation is deferred to the payout phase. This is known as an EET or *tax deferral regime*. Contrary to SHS tax systems, EET systems achieve fiscal neutrality between current and future consumption and create incentives to save for retirement.

As a compromise between progressive SHS and expenditure tax systems, several countries have adopted a *dual income tax* (DIT). The DIT is a particular form of schedular tax that applies a separate (generally lower) flat tax rate to all (personal and corporation) capital income and a progressive tax schedule to the sum of the taxpayer's income from other sources (e.g., labour and pension income). Tax credits and deductions are used to enhance horizontal and vertical equity. S*emi-dual income tax systems* levy different nominal tax rates on different types of capital income. A semi-dual income tax (SDIT) system is a particular form of schedular tax that levies different flat rates to some forms of capital (personal or corporate) income, while maintaining a progressive tax schedule on other sources of income. Finally, under a *flat tax system* a proportional (flat) tax rate is levied on all net income.

Taxation of public pensions

The general taxation regime of public pension schemes in Portugal may be classified as EET for employees and employers. Employer and employee contributions to public pension schemes are not taxed. Employer contributions are considered part of the payroll, and therefore deductible in computing the corporate income tax (CIT), whereas employee contributions are deductible for personal income tax purposes. Tax relief is unlimited and applied at the individual's/family marginal income tax rate. Public pensions are funded on a PAYG basis and partially financed by the general government budget (non-contributory benefits) and, hence, there are no returns on investments that could be subjected to, or exempted from, taxation. Notional capital (i.e., increases in pension entitlements through the revalorisation mechanism of contributions, indexed to productivity gains and inflation) are entirely tax-free.

[2] For a detailed analysis on the main approaches to taxing personal income see, e.g., OECD (2006).

Table 1

Overview of the taxation of public pensions in OECD countries

Tax regime	Country	Pension taxation regimes
E-E-T	BE, DK, EE, FI, GR, IT, LT, LU, AT, PO, SE, CH, SI, ES, CZ, CY, PT	Expenditure tax model, pension benefits treated as "deferred labour income"
t-E-T	FR, IR, CA, MT, NL, UK	Deferred comprehensive income tax model with double taxation relief
t-E-t	DE, US	Fragmented expenditure tax model
T-E-E	LI	Tax-free savings accounts, "prepaid expenditure tax model"
t-E-E	HU	Tax-free savings accounts,"reduced prepaid expenditure tax model"
E-E-E	SK	Full income tax exemption
T-T-E	None	Comprehensive income tax model

Source: Adapted from OECD (2011) and Wellisch et al. (2008).

On the tax treatment of pensioners, public pensions are considered as deferred labour income and treated as pension income and taxed at the individual's marginal income tax rate. The first EUR 4,104 of pension income is tax exempt regardless of its source. However, an extraordinary solidarity contribution (CES), introduced in 2011 and expanded as part of the "Troika" bailout programme, is paid on pensions above a certain amount. It also applies to private pensions and annuities paid by occupational pension plans. According to the Portuguese Personal Income Tax (PIT) system, Portuguese residents are taxed through IRS on their worldwide income on a self assessment basis and non-residents are subject to Portuguese tax on their Portuguese-sourced income at the applicable rates. Tax deductible expenses (e.g., contributions to retirement saving vehicles) are capped by an income-related global tax deduction amount. Total taxable income is subject to highly progressive tax rates, but contains a substantial zero-bracket amount that resulted in only relatively high levels of labour income being subject to the higher progressive tax rates.[3] As of 2015, there are five income bands with tax rates ranging from 14.5 to 48 percent (11.6 to 38.4 percent in the Azores islands). A 3.5 percent *additional surcharge* for PIT was introduced in September 2011 and is levied on annual taxable income exceeding EUR 7,070. For taxpayers in the top bracket, a 2.5 to 5 percent *Additional Solidarity Surcharge* is also levied. The progressivity of the tax system and the overall tax burden of households, particularly retirees, have significantly increased in recent years as a result of the 2013 PIT tax reforms that reduced the number of tax brackets, increased marginal tax rates and created surcharges.

Since 2015, labour and pension income have been treated equally, with the same PIT rates and deductions. By international comparison, the income threshold for the top bracket is one of the highest in OECD countries (together with Sweden and Denmark). Recent tax reforms have promoted a systematic differential treatment of investment income from income derived from other sources by using a common flat tax. To create a unified system that respects differences in the international mobility of income, tax rates applicable to income earned by residents and non-residents were made equal, with the exception of the regime for non-habitual tax residents detailed below. The semi-dualisation of the system aims to promote simplicity and stability. The general taxation regime of public pension schemes in Portugal is the most common type of scheme in OECD countries (Table 1).[4] Many OECD and EU countries apply a variant of the EET regime to public pensions, with contributions and returns on (real or notional) investment totally or partially taxed.

Taxation of occupational and personal private pensions

The general taxation regime of voluntary occupational and personal private pension schemes in Portugal may be classified as TET for employee or individual contributions and EET for employer contributions. The tax treatment for direct insurance schemes is the same as for pension funds. Employer contributions are fully deductible in computing the CIT if the plan provides individualised acquired right's benefits. If the pension plan benefits are "mere expectations" and a number of conditions

[3] Families with annual income below EUR 8,480 are PIT exempted. In 2015, about 2.5 million pensioners (circa 83 percent of total) will be exempt from PIT.

[4] See also Yoo and de Serres (2005) and OECD (2015).

Table 2

General tax treatment of private pension plans in OECD and non-OECD countries

Tax regime	OECD countries	Non-OECD countries
EET	Canada, Chile, Estonia, Finland, Germany, Greece, Iceland, Ireland, Japan, Netherlands, Norway, Poland, Slovenia, Spain, Switzerland, United Kingdom, United States	Croatia, Latvia, Romania
TEE	Czech Republic, Hungary, Mexico	Lithuania
ETE		Cyprus
TET	Austria, Belgium, France, Israel, Korea, Luxembourg, Portugal	Malta
ETT	Denmark, Italy, Sweden	
TTE	Australia, New Zealand, Turkey	
EEE	Slovak Republic	Bulgaria

Source: Adapted from OECD (2015).

are fulfilled[5], employer contributions are deductible in computing the CIT up to 15 percent of the annual total costs with wages and salaries.[6] If the contributions exceed the above limit, the exceeding part is not deductible for CIT purposes unless the amounts are included in the employee's taxable income. Social contributions are not levied on employer pension contributions. A flat CIT rate of 21 percent is levied on the global taxable income realised by companies resident for tax purposes in Portugal (also applicable to Portuguese PEs of foreign entities).[7] A reduced CIT rate of 17 percent applies to small and medium-sized companies on the first EUR 15,000 of taxable income.

As far as employee contributions are concerned, if the plan provides individualised acquired right's benefits, 20 percent of overall employee contributions to private pension plans (both occupational and personal) made prior retirement are tax deductible, up to a limit that varies according to the individual's age. In addition, the above mentioned income-related global tax deduction amount applies. If the pension plan delivers benefits that are considered mere expectations, there are no tax deductions and a tax deferral regime applies. As far as the tax treatment of returns on investments and accumulation of funds is concerned, the general rule is that income generated by private pension assets is tax exempt. Dividends, rental, interest and other capital income are VAT exempt. Pension funds are also partially exempt from property, municipal and stamp duty. When it comes to the tax treatment of accumulation of funds, there is no ceiling on the lifetime value of private pension funds. No tax applies on the accumulation of funds.

The tax treatment of private pension income depends on whether or not contributions were exempt and on the type of payout options chosen (annuities, lump sum). Taking benefits as programmed withdrawals is not allowed in Portugal. If the plan provides individualised benefits and the payout option is in the form of annuities, pension income is taxed at the individual's PIT rates. A maximum deduction of EUR 4,104 applies to total pension income. However, if the compulsory contributions to social protection schemes and to legal health subsystems exceed that limit, the deduction will be equal to the total amount of contributions. If contributions were exempt and pensioners choose to take accumulated capital as a lump sum, from 31 December, 2014, there is no tax exemption. Capital gains and other returns on the investment component are taxed at an autonomous rate of four or eight percent, depending on whether the contributions that originated such income were made before or after the 1st of January 2006, respectively. If contributions were taxed and the payout option is in the form of annuities, the contributions component of the accumulated pot is exempt, and only the capital gain and other returns on the investment component is taxed at the marginal PIT rates. If the contributions were taxed and pensioners choose to take accumulated capital as a lump sum, the contributions component is exempt, whereas capital gain and other returns on the investment part is taxed at an autonomous rate of four percent or eight percent, depending on whether the contributions that originated such income were made before or after the 1st of January 2006, respectively. With the exception of CES, social contributions are not levied on pension in-

[5] At least 2/3 of the benefits must be annuitised and the provisions of the general social security scheme are accompanied with regard to retirement age, the pension plan assets are not managed by the sponsor, the pension plan covers exclusively benefits in case of retirement, health (post-work), disability or survivorship.

[6] The limit is 25 percent if employees are not covered by social security.

[7] A lower CIT rate of 18.4 percent applies to companies that are tax resident in the Autonomous Region of Azores, including PEs of foreign entities registered therein.

Table 3

Evolution of Extraordinary Solidarity Contribution (CES) in Portugal

Year	Monthly pension	CES
2011	> € 5,000	10%
2012	[12-18] IAS	25% of the benefit payment between 12xIAS (€ 5,030.64) and 18xIAS (€ 7,545.96)
	>18 IAS	50% of the benefit payment above 18xIAS (€ 7,545.96)
2013-2014	€ [1,350-1,800]	3.5% of the monthly pension between € 1,350 and € 1,800
	€ [1,800-3,750]	3.5% of € 1,800 + 16% of the amount exceeding € 1,800 but below € 3,750
	€ [3,750-12 IAS]	10% of the monthly pension between € 3,750 and € 5,030.64
	[12 - 18] IAS	25% of the benefit payment between € 5,030.64 and € 7,545.96
	>18 IAS	50% of the benefit payment above 18xIAS (€ 7,545.96)
2015	[11 - 17] IAS	15% of the monthly pension between € 4,611.42 and € 7,126.74
	> 17 IAS	40% of the benefit payment above 17xIAS (€ 7,126.74)

Source: Author's preparation based on national legislation. Note: IAS = € 419.22 .
From the application of CES contribution in 2015 shall not result in a monthly pension of less than € 4,611.42.

come.[8] Comparing the taxation of private pension plans in Portugal with that of their international counterparts, we can observe that while Portugal applies a TET regime for employee or individual contributions and EET for employer contributions, many OECD and EU countries apply a variant of the EET regime (Table 2).

Taxation of investment income and capital gains

Portuguese residents are subject to PIT on all their investment income. For certain types of Portuguese or foreign-sourced investment income, residents may choose between being taxed at reduced withholding tax rates; or adding the income to the overall income and be taxed according to the general PIT rules. Interest from bank deposits in Portugal, interest on Portuguese bonds, dividends paid by Portuguese companies and dividends and interest paid by foreign entities may be excluded from overall income and taxed at a flat withholding tax rate of 28 percent. Contrary to the so-called "pure" version of the dual income tax, the tax rate on capital income is not aligned with the CIT rate. Non-residents are subject to PIT on their Portuguese-sourced investment income through withholding at the same withholding flat rates.[9] Capital gains arising from the difference between an asset's sale value and the corresponding acquisition cost are, in the case of shares, fully taxed at a 28 percent special rate.[10] Capital gains relating to immovable property acquired after 1 January 1989 are assessed to tax at progressive rates on 50 percent of their value. As to land for construction, it is subject to tax irrespective of the date of acquisition. Capital gains on the sale of unlisted equity of micro and SME companies are only taxable at a share of 50 percent. Portuguese residents are subject to PIT on the capital gains relating to Portuguese and/or foreign assets. Non-residents are only subject to PIT on their Portuguese-sourced capital gains relating to immovable property. Property Rental Income is subject to tax at 28 percent, or added to other categories of income after deducting all maintenance and repair expenses and Municipal Property Tax (IMI). There are no wealth, inheritance and gift taxes in Portugal. There are no property taxes in Portugal, other than IMI.

Taxation of investment funds income

Investment funds benefit from a favourable tax treatment in Portugal based on the principle that the holder of the units will have the same tax treatment than if it had invested directly in the assets held by the fund. From 1 July 2015 onwards, Collective Investment Vehicles (CIV) established and operating according to Portuguese law are taxed on profits, being however exempt, among others, investment income, rental income and capital gains, unless that income derives from "offshore" entities. Tax losses generated by CIV now follow the regime foreseen in the CIT code. The taxable income is subject to the general CIT rate. Municipal and state surtax are not applicable. With proper adjustments,

[8] The interest income subject to taxation can be reduced if over 35 percent of the contributions are paid in the first half of the contract, and the benefits are received over five years after the beginning of the contract (five to eight years: 80 percent of the interest is taxed; more than eight years: 40 percent of the interest is taxed). Otherwise, an autonomous normal 21.5 percent rate is levied on interest income subject to taxation.

[9] Investment income paid by non-resident entities without a permanent establishment in Portugal, domiciled in jurisdictions with more favourable tax regimes, is liable to an autonomous tax rate of 35 percent.

[10] Realised capital gains are included in taxable profits for corporate tax purposes, but gains on the disposal of shares may be exempt from tax under Portugal's "participation exemption regime".

Table 4

Social security contributions on pension income

Country	Social security contributions on pension income
Portugal	Special solidarity contribution between 15% and 40% of monthly benefits.
France	General scheme for employees (RGAVTS) and Complementary schemes for employees (ARRCO) and management staff (AGIRC): Generalized social contribution (CSG) of 6.6%, 3.8% or exemption (according to taxation); contribution for the repayment of the social debt (CRDS) of 0.5%; additional solidarity contribution for independent living (CASA) of 0.3%; Complementary schemes for employees (ARRCO) and management staff (AGIRC): Contribution of 1.0%.
Belgium	Solidarity contribution in the field of pensions varying from 0.5% to 2% according to the family charge and the gross amount of all statutory and non-statutory pensions. Minimum amount for pension is € 2,569.12 (couple) or € 2,222.18 (single) per month.
Italy	Contributo di solidarietà for pension benefits above 5 minimum wages (Fornero reform); Current rules establish contribution rates between 6% and 18% for pensions above 14 minimum wages; Contributo di perequazione, 2011 (5%-15% for annual benefits above € 90,000).
Norway	Pension income is subject to social security contributions at a comparatively lower rate.

Source: OECD (2015) and MISSOC Comparative Tables Database with author's additions (MISSOC 2016).

autonomous taxation is also applicable. Stamp tax rates range between 0.0025 and 0.0125 percent. The taxation "at exit" rule is applicable to the taxation of income obtained by individual holders of participation units/ shareholdings in the CIV. For individual investors resident in Portugal for tax purposes, income distributed by the CIV and gains on the redemption are subject to a definitive flat withdrawal holding tax (WHT) rate of 28 percent, unless investors opt to be taxed on their overall income. Net capital gains are taxed at a WHT rate of 28 percent. For corporations, income distributed by the CIV is subject to WHT at a flat rate of 25 percent. Capital gains are not subject to WHT, as they are included in annual taxable profit. With some exceptions, foreign investment funds are only taxed on income obtained in Portugal at a WHT tax at a rate of 25 percent.

Social security contributions levied on pension income

In Portugal, health care systems are not included in social security. As such, like in most OECD countries social security contributions are levied only on gross labour income, and used to finance pension, unemployment, sickness, death, family and maternity benefits. Before 2011, pension income was exempt from social contributions. However, in 2011, the Portuguese government was under pressure to consolidate the budget and was forced to adopt reforms with significant short-term effects, one of which was the introduction for the first time of an extraordinary (social) solidarity contribution (CES), levied on public and private pensions above a certain amount. Politically advocated and justified as being a temporary measure to broaden the social contributions tax base, part of a policy to spread the burden equally between different cohorts of citizens and generations (both active and retired), the argument found no general acceptance. The measure soon became one of the main issues in the national political debate, focusing on the question of whether there were legal boundaries to how much pension reforms could impact on the 'acquired rights' of pensioners, on whether CES took into account the principle of progressivity and proportionality in the PIT tax code, and on the extent to which CES could, being a social surcharge on PIT rates, constitute a second tax on the same pension income. The Portuguese Constitutional Court has been requested to rule on the matter several times in the last four years, and has decided in favour of government at times, and the Court found the measures unconstitutional and overruled them at others, and ordered to fully or partially reimburse the pensioners affected. In reality, CES was simply an alternative way to nominally reduce pension benefits, similar to the reductions that would be obtained through direct cuts, temporary freezes and/or permanent reduction of the indexation of benefits. Despite serious Constitutional Court remarks, the contribution was reformulated many times during this period to increase the taxable base and/or the number of tax brackets (Table 3).

For some groups of pensioners, CES actually imposed a ceiling on pension benefits. The majority of European Union countries do not charge any social security contributions on public and private pension benefits, and those who do it mostly refer to health, sickness or long-term care insurance coverage (OECD 2015). Current relevant

exceptions are Portugal, France, Belgium, Norway; a former exception was Italy (Table 4).

In Portugal lump sum payments from occupational pension plans are exempt from CES. This means annuitisation is fiscally discriminated compared to other payout options. Personal private pension funds and saving schemes are also exempt from CES, which means that equal treatment regarding the retirement saving vehicle has not been assured.

A place in the sun and a tax-free pension: PIT regime for non-regular residents

In 2009 Portugal implemented a PIT system for the non-regular resident with the purpose of attracting to Portugal non-resident professionals qualified for activities with high added value, intellectual or industrial propriety or knowhow, as well as beneficiaries of pension schemes granted abroad, offering a more beneficial tax burden. The non-regular resident tax regime is available for citizens deemed resident on Portuguese territory for tax purposes in the year to be taxed as a non-regular resident, that have not been deemed resident on Portuguese territory during the prior five years. Once granted, the regime applies for ten years (non-extendable) provided that, in each year, the individual meets the criteria to qualify as a tax resident. For pensioners, the main advantage of this regime is that it offers tax exemption on pension income provided that (i) income is taxed in the country of its source based on the double tax treaty rules, or (ii) cannot be considered as Portuguese source income under the Portuguese domestic rules. Given the widely implemented system of deferred income taxation of pension benefits in most OECD countries, this special regime offers Portugal a significant competitive advantage in the cross-border taxation of pension income, but raises problems of international tax equity and neutrality, particularly when retired emigrants were exempted from income tax on their old-age pension saving in their home country.

Is there a rationale for a semi-dual income tax in pension taxation?

Pension taxation should contribute to create an adequate, affordable, sustainable, equitable and efficient pension system, comprising mechanisms for individuals and households to smooth consumption over time, to insure against risks and to protect against the risk of poverty in old age. The taxation of pensions directly affects consumption, saving, work and leisure decisions, affects asset allocation decisions and public finances. It therefore has direct implications for capital accumulation, productivity, economic growth, capital markets and welfare. When deciding on a specific tax system, consistency with recent pension reform trends that seek to raise the regular retirement age, provide incentives to work longer and to abstain from early retirement, promote privately-funded pension regimes, which complement or partly replace public pensions or increase adequacy for retirees at the bottom of the income scale, should be considered. Apart from the implications for income distribution and public revenue, additional considerations like tax neutrality, tax equity, risk sharing between governments and households, distributive consequences (income and wealth), opportunistic behaviour, the need to simplify the tax system, to increase transparency or to reduce administration costs should also be taken into account.

The DIT was introduced in the Nordic countries in the early 1990s as a compromise between SHS tax and expenditure tax, the two opposite poles recognised by conventional tax theory for a personal tax based on the ability to pay principle. Since then, Portugal and other EU countries have gradually moved towards an SDIT tax. The question that naturally emerges is then: to what extent is SDIT a system that, compared to TTE or EET, is better suited to address the personal and policy goals of a pension scheme and of the economy? Is there a theoretical or practical rationale for an SDIT in the taxation of occupational and private pensions and other retirement income? What are the arguments for and against DIT and SDIT in the context of pension taxation?[11] Is there a rationale for taxing capital income at (a) lower marginal rate(s) than other income? Why should we combine a flat tax on capital income with a progressive rate schedule for labour and pension income? In making this discussion, besides the normal pension scheme goals, we will assume there are four main competing considerations an open economy faces in designing a pension taxation regime. At the domestic level, the main goals are *tax progressivity*, tax *comprehensiveness*, and tax *symmetry*. At the international level, the main goal is *competitiveness*, but issues like the *portability of pension entitlements* and *discriminating tax treatment* in the Single Market can run counter to all the four freedoms laid down in the EC Treaty. In a closed economy, an SHS tax can theoretically satisfy the three domestic objectives. When international competitiveness is add-

[11] For a detailed discussion on the merits and drawbacks of DIT see Sørensen (1994, 2005) and Boadway (2004).

ed to the equation, countries may not be able to fulfil all goals, particularly as cross-border mobility of capital varies both between types of capital and economic regions, and will have to sacrifice or compromise some of them. As the recent Portuguese experience shows, economic, political and social factors will ultimately determine which objective(s) to sacrifice.

Sacrificing comprehensiveness: The central role of savings taxation

Countries that adopted DIT and SDIT systems abandoned comprehensiveness, i.e., the joint treatment of capital and non-capital incomes, in an attempt to maintain "symmetry" while at the same time responding to strong tax competitive pressures. SHS tax discriminates in favour of current consumption, it is not neutral with regard to present and future consumption and acts as a disincentive to (particularly long-term) saving. Savings, particularly contributions to pension schemes, are not a normal commodity, and for most individuals they are a way to finance deferred consumption. The taxation of savings has a central role in the tax treatment of pensions. Pension taxation can affect both the total amount of savings in the economy and how those savings are allocated across different assets. This can directly affect the amount and efficiency with which capital is invested. Under an SHS tax, saving out of current income is double-taxed. This means that when stated in life-cycle perspective, horizontal equity is violated under an SHS tax. Applying a lower capital income tax rate in SDIT is seen as a way to mitigate the bias against future consumption and to alleviate the impact of taxing nominal (not real) rates of return. TEE systems shift the tax burden to working-aged agents and away from retirees.

There are additional arguments that help to justify a more favourable fiscal treatment of capital income and retirement saving in Portugal. Among them we highlight the desire to increase the number of people that save (and the amount saved) to finance their retirement, boosting national savings, increasing the importance of retirement saving vehicles and contractual savings institutions in financial markets, bounded rationality and bounded willpower problems (because of low financial literacy levels), the desire to reduce the currently high number and significance of those that are likely to fall into the safety net when in retirement, increasing the supply of long term funds to capital markets and promote investment and economic growth. Saving for retirement is particularly low in Portugal and will need to increase significantly in the future to address sustainability and adequacy problems in PAYG systems and to reduce pension expenditure.

Sacrificing symmetry: International capital mobility and other constraints

The international capital mobility constraint.

Portugal is a small, significantly open economy with perfect international mobility of capital that critically depends on foreign savings to counterbalance its significant public and private indebtedness levels. Recent banking failures and financial markets distress have also contributed to undermine the attractiveness of investing in Portugal. In recent years global tax competition concerns in Portugal have prompted legislative proposals to reduce CIT rates significantly below tax rates under the PIT tax system. This option sacrifices symmetry objectives. The option pursued in Portugal to differentiate tax rates on capital income has been largely determined by the elasticity of the tax base. Tax rates on the most sensitive types of capital income (e.g., dividends) are taxed under lower flat rates, while others are taxed under higher flat WHT rates or, optionally, kept within the ambit of progressive income taxation. Portugal's adoption of an SDIT tax, the separation of the several flat capital income tax rates from the labour and pension income tax schedule allowed policy-makers to levy comparatively lower capital tax rates, to reduce the risk of capital flight and to increase the attractiveness of FDI.

The problem of defining the capital income component.

Some forms of capital income are simple to define in principle (e.g., interest income, dividends) and Portugal decided to tax them (by default) at a flat rate under a final withholding regime. This is expected to improve efficiency by increasing the symmetry of tax treatment of capital income and to simplify administration. Flat tax rates have increased significantly (40 percent) in recent years. This is against both the goal of encouraging people to save more and the objective of allowing individuals to take personal responsibility for adequate income in retirement. The adoption of final WHT regimes has expanded the tax base and is likely to enhance the progressivity of the tax system. Given this, the question of whether and how to tax net capital gains on corporate shares or real estate property at the individual level was discussed for many years in Portugal and suffered many changes. In the past, the option was simply to exempt capital gains from taxation, because of competitiveness considerations and the need to develop capital markets.

Then, for some years the option was to tax net capital gains only for shares held for less than a specific period of time (one year). This approach is assumed to create incentives to long-term (retirement) capital market investment, support privatisation processes and to prevent taxpayers from engaging in schemes to avoid tax on labour income by selling their shares to reduce or evade tax liability. The current practice is to tax net capital gains at the individual level by a flat rate of 28 percent. Taxing capital gains based on the realisation principle may lead to asset retention and lock-in effects, which hampers the optimal allocation of resources.

The fiscal revenue and unemployment constraints.

Portugal has significant deficit, public debt, social expenditure and unemployment levels and its marginal PIT rates are already among the highest among OECD countries. It will thus be very difficult to compensate lower marginal tax rates on retirement capital income by increasing labour income taxes further. Contrary to the pure form of the DIT, the PIT rate on capital income is not aligned with both the CIT rate and the marginal tax rate on labour income in the first bracket. The fiscal revenue constraint is likely to prevent further significant reductions in capital income tax rates.

Arbitrage opportunities and the erosion of social contributions' taxable base

The move from an SHS tax to an SDIT tax in Portugal offered significant tax planning (or tax evasion) opportunities by converting labour income from self-employment or from wages of owner-employees of closely-held corporations into income from capital. For medium- and high-income classes, there is a large difference in the marginal tax rates on capital and labour income, providing great incentives for income shifting from labour income to capital income. Since 2013, the combined reduction in the number of PIT tax brackets, the increase in PIT marginal rates and surcharges and the ongoing reduction in CIT rates to values now closer to the lowest marginal tax rate on labour and pension income have created a strong incentive to characterise income from labour as income from capital. Given that under the Portuguese (and many other countries') tax system labour income is subject to social security taxes, the move towards SDIT has substantially increased the effective marginal tax rates for labour income, but left tax rates for income from capital unchanged. As a result, the number of those registered self-employed has declined substantially in recent years and the number of new SMEs grew exponentially. For pension schemes, the immediate consequence has been a decline in the taxable base for social contributions and corresponding contribution revenue, challenging its already problematic short- and long-term sustainability.

Equity, neutrality and risk-sharing considerations

Tax equity has always been a critical point in tax policy design in Portugal. The question of how tax equity is perceived in the SDIT tax model is a key point in the debate and, as such, it should be approached from various angles. First, there is not a consensus on what constitutes a socially acceptable indicator of a citizen's ability to pay, the basic principle of the income tax legislation in Portugal, and what the after-tax income distribution patterns should be. Assuming that annual comprehensive income is a socially acceptable indicator of a citizen's ability to pay, an SHS tax ensures horizontal equity and, for a given consensus about the redistributive features of the system, properly graduated tax scales also guarantee vertical equity. However, when stated in life-cycle perspective, horizontal equity is violated under an SHS tax. Neutrality over the timing of consumption should only be a reasonable starting point for tax design of pensions and retirement income. The taxation of savings affects individuals' decisions on how much to save, when to save, how to allocate savings across different assets and how much risk to take when allocating their savings between assets. The appropriate treatment of retirement savings and pension income should not neglect the impact of a given taxation regime on portfolio composition and risk taking. Moving now to the payout phase, there are important welfare effects that can justify sharing longevity risk between annuitants and annuity providers and the adoption of a tax deferral regime.

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