RESEARCH SERIES
NUMBER 14
NOVEMBER 2009

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This paper is available online at www.esri.ie
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ISBN 978 0 7070 0293 4

ACKNOWLEDGEMENTS

We are grateful to the referees for helpful comments on an earlier draft. Thanks are also due to Philip O'Connell and Frances Ruane for valuable suggestions. We owe a particular debt to Brian Nolan for his advice on a number of key issues. We bear sole responsibility for any remaining errors or obscurities.

Preparation of the document for printing was undertaken with their usual skill and efficiency by Deirdre Whitaker, Mary Cleary and Regina Moore; we are indebted to them for the care and attention to detail they have shown.

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EXECUTIVE SUMMARY

Context

Pension systems world-wide face major long-term challenges in providing adequate incomes in retirement to an ageing population. Ireland is no exception. While at present there are more than five people of working age for each person of pension age, by 2061, assuming pension age is unchanged, there would be no more than two. Defined benefit (DB) schemes have come under particular pressure, and a shift from defined benefit to defined contribution (DC) schemes has been evident in Ireland as in other countries. In part, this reflects the fact that DB schemes tend to place the risk arising from increased longevity on the scheme funder, whereas DC schemes limit the liability of the funder but put a greater risk on the pension-holder. The government's *Green Paper on Pensions* explored how the Irish pensions system might best be reformed to address the challenges of providing adequate pensions at an affordable cost in the context of increased longevity. In doing so, it raised a number of key questions for consideration. This study is designed to provide new evidence on some of these questions, relating mainly to the structuring of tax incentives to encourage improved coverage of private pensions. Earlier this year the government introduced a "Pension-related Deduction" – more commonly called the public service pension levy. We examine the nature of this policy instrument, and how it is to be interpreted.

International Evidence

To what extent do tax incentives induce new savings for retirement? Also to what extent do they simply subsidise pension contributions which would have taken place in the absence of the incentive, or lead to a reallocation of savings towards the tax-favoured option, rather than a net increase in savings. These issues have been extensively investigated in both the US and the UK, where tax incentives for retirement saving have been much used. There is, as yet, no consensus on this. Some recent studies of Individual Retirement Accounts in the US, and Tax Exempt Special Savings Accounts (TESSA) and Individual Savings Accounts (ISA) in the UK conclude that only small fractions of the amounts saved in these schemes represented new savings. The corollary is that these policies have been an expensive means of encouraging saving, with large deadweight losses associated with the reshuffling of existing savings. Other studies see policy changes encouraging individual retirement accounts as having contributed to an enormous increase in defined contribution plan assets and more than offsetting declines in defined benefit plans. Whatever about the overall impact on new savings, it has been found that households who normally save the most were largely contributing funds that they would have saved anyway. Taken together, these results suggest that tax incentives do face a substantial "deadweight" problem, of subsidising savings that would take place anyway; and that this is particularly so for those at higher incomes.

Framework

We explore the direct impact of changes in the tax treatment of pensions using the *SWITCH* tax-benefit model. The model simulates the tax liabilities and benefit entitlements of a nationally representative sample of households – the data are drawn from the CSO's Survey on Income and Living Conditions (EU SILC) for 2005. A weighting scheme is used to adjust the data to represent the demographic situation in 2030 and 2050. All of the model results are based on the technical assumption of no change in behaviour. The fact that social welfare entitlements are incorporated in the model means that it is possible to analyse the direct impact of restrictions on income tax relief, coupled with an increase in social welfare pensions. These results could equally be interpreted in terms of changes in taxes helping to sustain existing levels of payment.

Implications of Long-run Changes in Pension Coverage

Before analysing potential policy changes, we examine the potential impact of trends towards increasing coverage in occupational and private pensions, and in qualification rates for the contributory State Pension. Occupational/private pension coverage among current pensioners is about 30 per cent, but stands at about 60 per cent for the over 30s. This difference reflects the fact that the rate of pension coverage has been rising over time. If this higher rate of coverage is sustained then future pensioner populations will be more likely to have an entitlement to a private or occupational pension than the current cohort of pensioners. What implications would this have for the "at risk of poverty" measure for future pensioners? We estimate that this factor could reduce the "at risk of poverty" measure by about one-third – both in terms of the familiar head count ratio, but also in terms of broader measures taking account of the depth of poverty. In a similar fashion, we analyse the impact of increased rates of qualification for the contributory State Pension. This factor could lead to a reduction in the head count of poverty of about one-fifth, and would also help to reduce the depth of poverty.

Tax Treatment of Pensions

Debate about the appropriate tax base has, in the past, often been characterised as a contest between an income base and an expenditure base. More recent reviews of this area conclude that the optimal tax system contains some form of taxation of capital income, and a more productive question is how to tax capital income, given that earnings are subject to tax.

In this context we examine some possible changes to the current tax treatment of pensions, which can be characterised as following expenditure tax lines, while most direct taxes operate using income as a base. One alternative is that relief on contributions could be restricted to the standard rate of tax. This would imply a reduction in income tax relief for top rate taxpayers, but no change for those paying the standard rate. Our main findings include the following:

- Standardisation of relief on all pension contributions (employee, employer and implicit government contributions) could raise revenue of over €1,000 million per annum.
- More than four-fifths of the revenue raised would come from the richest one-fifth of tax units.

- Revenue raised could be applied to sustaining State pension levels as demographic pressures on the financing of public pensions intensify.
- An increase in the relief from the standardised level to allow relief at a hybrid, 30 per cent rate – an option similar to that recommended by the Commission on Taxation would lead to gains which are concentrated on those with high incomes; but compared to the present situation would involve gains for standard rate taxpayers and losses for top rate taxpayers.

Currently, tax relief on pension contributions is of greatest value to those with incomes high enough to pay the top rate of tax. Evidence from UK and US studies suggests that there is significant deadweight loss associated with such incentives, and that there are a number of key factors outside of tax incentives which can be changed to promote greater pension coverage. Our reading of this international evidence, and of our own findings, is that take-up of pensions among those on low to middle incomes would be best tackled by measures addressing the decision costs which pose an obstacle to enrolment in pension schemes. These could include what the Green Paper terms a "soft mandatory" scheme, in which the default option is enrolment in the scheme, but individuals may exercise their right to opt out; and a system of partial matching of contributions, at a single rate, rather than tax relief.

Public Service Pension Levy (Pension-Related Deduction)

The pension-related deduction was introduced in response to a crisis in the public finances. Should it now be regarded as a temporary measure, to be reversed or revised? Or should it be seen as a new instrument of policy for the longer term, giving government new leverage to attain goals with respect to public finance outcomes, public-private sector wage differentials and/or income distribution? Our analysis suggests some caution is appropriate in thinking about a future role for the pension-related deduction.

Perhaps the strongest rationale for the pension-related deduction is that it serves as a mechanism for reducing net public sector spending, while avoiding the political economy difficulties of reducing wage rates explicitly. However, there are serious disadvantages associated with achieving the cost reduction in this fashion, which involves concentrating the burden of adjustment on those currently in employment, while they are in employment. An explicit wage rate reduction would also reduce the incomes of current *and future* pensioners. The pension-related deduction does not do this. In this way, it increases the replacement rates for public sector workers facing retirement decisions – tending to reduce labour supply, in a similar way to an income tax increase. Moreover, the progressive structure of the levy may damage labour market efficiency in the public sector. Broader tax/welfare measures to achieve distributional and anti-poverty goals may be more appropriate.