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PRIVATE PENSIONS AND EQUITY IN IRELAND AND THE U.K.

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Abstract

The strong link between private pensions and employment status means that there is little interest in the equity of private pension arrangements since it is expected that inequality in earnings will be reproduced in inequality in pensions. Nevertheless, the equity of private pensions is an issue as governments in mainly English speaking OECD countries subsidise their provision through the tax system and governments in a number of EU countries are now considering this policy as a way of coping with increases in long-term pension costs due to ageing of their populations.

The favourable tax treatment of private pensions provided in Ireland and the United Kingdom is outlined and compared with the tax treatment of private pensions in OECD countries. It is shown that the annual cost of tax expenditure on pensions amounted to over 1 per cent of GDP in both countries in 1997, that it substantially exceeded the cost of their means-tested social assistance schemes and amounted to two-thirds of direct expenditure on social insurance pensions in Ireland and to one-third in the U.K. Evidence relating to the distribution of pension tax expenditure shows that the present tax treatment of private pensions is inequitable as about two-thirds of the benefits accrue to the top two income deciles in both countries and 3 per cent or less to the bottom two deciles.

Proposals for containing the cost of public pension systems in Europe by relying on greater private pension provision in the future can learn from experience in Ireland and Britain that using tax incentives to promote private pension provision could impose substantial costs on the Exchequer. The regressive nature of such incentives means that all taxpayers have to pay more taxes to provide benefits which accrue overwhelmingly to higher income taxpayers.

PRIVATE PENSIONS AND EQUITY IN IRELAND AND THE U.K.[1]

1. Introduction

It is well known from sample surveys that the coverage of occupational and personal pension plans is very uneven in terms of occupation, industry, sex, age income and other characteristics[2]. There is also evidence that workers with the same income and the same number of years service receive very different incomes in retirement because their pensions are provided by different private pension companies[3]. These results can be seen as the expected outcome of job choices, variations in preferences between present and future consumption, differences in the income elasticity of demand for a pension, and differences in attitudes to risk. In short, private provision of pensions is not expected to be equitable in the sense that almost everyone will be a member of an occupational or personal pension plan or will receive the same pension as someone with the same work history or contribution record. Why then should we be concerned about private pensions and equity?

One of the major, yet most neglected, reasons is that some governments subsidise the provision of occupational and personal pensions through the tax system by granting tax exemptions and deferments for pension saving. They justify the more favourable tax treatment of pension saving on economic and social grounds. On economic grounds, it is argued that tax incentives encourage long-term saving by increasing the rate of return on pension investment. This raises investment and the capital stock and over time it should result in an increase in output of goods and services from which pensions can be paid in the future.[4] On social grounds, it is argued that it is desirable to give tax incentives to encourage people to make provision for their own retirement.[5] These arguments originated primarily in English speaking countries (Australia, Canada, Ireland, New Zealand, the United Kingdom, and the United States) which used funded private pension schemes to provide income-related pensions to supplement the basic State pension.

Similar arguments are now being made in a number of EU countries (Finland, France, Germany, Italy, Portugal, Spain) by governments which believe that greater reliance on private funded pension schemes provides the best way of coping with increases in long-term pension costs due to projected increases in the future in the proportion of older people in the population. A striking feature of arguments for greater reliance on private pension provision is that the cost of pension tax reliefs are generally omitted from projections of the relative cost of public and private provision

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[1] This paper is based on recent work on pension tax expenditure in Ireland by Hughes (2000) and in the U.K. by Sinfield (2000) and Agulnik and Le Grand (1998). I am grateful to Adrian Sinfield for stimulating my interest in tax expenditure on pensions, for helpful discussions on measurement issues, and for supplying data on the cost of pension tax reliefs for the U.K. I am also grateful to him and to participants at an LSE conference in January 2002 on *Modelling Policy for an Ageing Europe* for comments on an earlier draft.

[2] For Ireland see Hughes and Whelan (1996) and for the U.K. see HMSO (2001b).

[3] The ILO (2000) provides evidence of such outcomes in Chile where the public pension system was replaced with a compulsory private pension system.

[4] See Feldstein (1998).

[5] See National Pensions Board (1988).

and that little attention is paid to the effect which redistributing income through the tax system may have on income inequality in old age.[6]

Income tax reliefs on such items of personal expenditure as pension contributions, health contributions, and mortgage repayments amount, in effect, to expenditure programmes delivered through the tax system. The term “tax expenditure”, introduced by Surrey (1973), is used to indicate that these reliefs are not part of the benchmark tax system and that the foregone revenue is equivalent to direct government expenditure. It is appropriate, therefore, that policies which result in tax expenditure on private pensions should be judged by the same criteria as direct expenditure programmes and that the same equity principle should be used to evaluate their effect on the income distribution.

This paper will present evidence on the cost and distribution of tax expenditure on private pensions which indicates that the Exchequer incurs significant costs through greater reliance on private pension provision and which suggests that the tax treatment of private pension plans is inequitable. Section 2 provides an overview of the different regimes which are used to tax pension saving in OECD countries. Section 3 presents evidence on the cost of tax expenditure on occupational pensions relative to GDP in Ireland and the U.K. and Section 4 compares the cost of their tax expenditure on private pensions to direct expenditure on public pensions. Section 5 shows how the benefits of the tax expenditure on employee contributions to occupational schemes in Ireland and to occupational and personal pension plans in the U.K. are distributed by income group. The results are summarised in Section 6.

The intention in presenting data on the cost and distribution of tax expenditure on pensions for Ireland and the U.K. is to use them as examples to show that in countries which rely heavily on private pension provision the costs to the Exchequer can be substantial and that implementing pensions policy through the tax system is likely to increase income inequality in old age. There are important differences in the cost and distribution of Exchequer support for private pensions in the two countries, which may be due to the greater maturity of occupational pension schemes in the U.K. and to the fact that there are personal pension plans in the U.K. but not yet in Ireland. However, it is not the purpose of this paper to make direct comparisons of the cost and distribution of pension tax expenditure between the U.K. and Ireland or to try and explain the differences.

2. Pension Tax Regimes in OECD Countries

Since the early 1980s the Revenue Commissioners in Ireland and the Inland Revenue in the United Kingdom have published annual estimates of the cost to the Exchequer of tax support for private pension schemes Their estimates show that the cost of the exemption of the net income of private pension plans has generally been one of the largest items in the list of tax expenditures.[7]

[6] Some examples of studies advocating greater reliance on private pensions which omit consideration of the cost of tax expenditure on pensions are World Bank (1994), Edey and Simon (1998), Budd and Campbell (1998), Feldstein and Samwick (1998), Borsch-Supan (2000), and Mantel and Bowers (2000).

[7] Official estimates of the cost of tax expenditures on pensions show that the same is true in Australia (Knox (1991), the United States (Munnell (1991)) and other OECD countries (OECD (1996)).

Despite this, and the use by the pension industry of the tax favoured treatment of pensions as a major selling point, the industry's representative body in Ireland, the Irish Association of Pension Funds (IAPF), argues that the Exchequer ultimately gets back most of the tax foregone on pension contributions and fund income through the taxation of pension benefits. For example, the IAPF (1998, p. 1) argues that "it is a common misconception that pension funds are exempt from tax" because "they actually operate on the basis of deferred taxation NOT no taxation" and that "the exemptions are balanced by the eventual taxation of benefits (except, of course, in relation to the lump sum) so the net effect is a tax deferral rather than an outright exemption" (IAPF (1999, p. 1)). The Pensions Board, the Irish government's advisory body on pensions, appears to share this view as it argues in a recent report (Pensions Board (1998 p. 146)) on developing the national pension system that "the tax treatment of pensions, other than lump sums, is essentially tax deferral." Its predecessor, the National Pensions Board (1988), argued that "the present tax treatment of pension funds is simple to understand and operate, is broadly equitable and clearly acts as a major encouragement to the establishment of funded occupational pension schemes."

In recent years the representative body in the United Kingdom, the National Association of Pension Funds (1999, p. 1) has argued for the introduction of a "tax 'league table' of pensions, savings and investment vehicles so that the tax regime can concentrate on the areas which make the greatest contribution to taking people out of dependence on State social security benefits, especially in retirement." The advantages of approved private pension plans coming top of this league table, according to the NAPF (1998, p. 2) are that "in the long run dependency on state benefits and Government expenditure on welfare will be reduced, while the Exchequer will benefit from higher pensions in payment." The implicit suggestion in this argument appears to be that the combination of reduced welfare expenditure and increased tax revenue from private pensions will not only cost the Exchequer nothing, but will actually make it better off.

The primary basis for raising taxes in OECD countries is income. Under an income tax regime pension contributions are taxed (T), the investment income and capital gains of the pension fund are taxed (T), and pension benefits are exempt (E). However, because of the desire to encourage people to save for their own retirement, some countries exempt the interest earned on pension saving from tax. If all forms of saving were exempt from tax it would be equivalent to having consumption, rather than income, as the basis for taxation. Under a consumption tax regime pension contributions are exempt (E) from tax, investment income and capital gains are exempt (E), and pension benefits, including lump sums, are taxed (see Dilnot (1992)). An income tax basis for taxing pension saving is described as a TTE regime and a consumption tax basis is referred to as an EET regime. Countries which mix elements of an income tax and a consumption tax regime to tax pension saving have a hybrid regime.

Table 1 provides a broad summary of the regimes which were used to tax occupational pensions in OECD countries around 1993. From the first three columns of the table it is evident that a majority of countries favour a consumption tax regime. The main exceptions are New Zealand, which has moved to an income tax regime,

Table 1: Tax Regimes for Occupational Pensions in OECD Countries Around 1993

Country	Contributions	Pension Fund	Pension Benefits	
			Income	Lump Sum
Belgium	E	E	T	(t)
Canada	E	E	T	Unavailable
France	E	E	T	Unavailable
Germany	E	E	T	T
Ireland	E	E	T	E
Luxembourg	E	E	T	T
Netherlands	E	E	T	Unavailable
Norway	E	E	T	Unavailable
Portugal	E	E	T	(t)
Spain	E	E	T	T
Switzerland	E	E	T	T
United Kingdom	E	E	T	E
United States	E	E	T	Unavailable
Denmark	E	(t)	T	T
Sweden	E	(t)	T	Unavailable
Finland	(t)	E	T	T
Austria	(t)	E	T	T
Australia	(t)	(t)	(t)	(t)
Iceland	T	E	T	T
Japan	T	E	T	(t)
New Zealand	T	T	E	T

Sources: OECD (1994), Whitehouse (1999), Hall (2000), Dilnot and Johnson (1993), and Dalsgaard (2001).
Note: A small t indicates that the component is taxed at a lower rate than the standard rate of income tax.

and some of the Nordic countries, Austria, Australia, Iceland, and Japan which use a hybrid regime. Almost half of the countries in Table 1 allow some or all of the pension benefit to be taken in the form of a lump sum payment on retirement. Ireland and the United Kingdom stand out in this group as the only countries which totally exempt lump sum benefits from tax. All of the other countries which allow payment of lump sum benefits tax them at standard or lower rates of tax. Income limits exist in the United Kingdom, the United States and other OECD countries on the maximum benefit which defined benefit schemes can provide and there are contribution limits for defined contribution schemes, as there are in Ireland for both defined benefit and defined contribution schemes[8].

How do the different approaches to the taxation of pension saving, shown in Table 1, operate in practice? This question was investigated some years ago by the

[8] The income cap in the United Kingdom is currently £91,800 sterling; the maximum benefit allowed in the United States in 1996 was $120,000. In 1997 both the U. K. and Ireland changed the tax treatment of Advanced Corporation Tax for tax exempt investors such as pension schemes thereby reducing somewhat the tax-favoured position of pension saving relative to other forms of saving.

OECD (1994). It adapted a method of measuring incentives for saving and investment, which King and Fullerton (1984) developed for the corporate sector, to estimate the marginal effective tax rate on different forms of household saving within the tax systems operating in OECD countries in 1993. The effective marginal tax rate is defined as the difference between the rate of return before and after tax on pension saving over time. The tax rates are calculated for those paying at the marginal rates applicable to the Average Production Worker and to top rate taxpayers. The results presented in Table 2 show the marginal effective tax rates on pensions and income for the two types of household using the common OECD inflation rate of 3.7 per cent on

Table 2: Marginal Effective Tax Rates for Employer-Sponsored Pension Schemes and Marginal Tax Rates for an Average Production Worker and a Top Rate Taxpayer in OECD Countries in 1993

Country	Average Production Worker		Top Rate Taxpayer	
	Pension	Income	Pension	Income
Australia	-3.9	39.4	-26.5	48.4
Austria	-12.5	32.0	-21.4	50.0
Belgium	53.0	45.0	61.4	55.0
Canada	0.0	41.5	0.0	49.8
Denmark	20.6	52.1	20.6	58.1
Finland	37.3	49.0	37.3	60.0
France	0.0	27.1	30.2	59.9
Germany	0.0	29.1	0.0	53.0
Iceland	73.4	41.3	73.4	41.3
Ireland	-10.4	27.0	-27.2	48.0
Japan	21.7	20.0	61.7	50.0
Luxembourg	0.0	30.0	0.0	52.5
Netherlands	0.0	38.4	0.0	60.0
New Zealand	67.8	24.0	67.8	33.0
Norway	34.9	44.0	33.7	43.5
Portugal	-12.5	25.0	-24.0	40.0
Spain	0.0	24.5	0.0	56.0
Sweden	16.5	34.3	16.5	51.0
Switzerland	1.4	21.7	1.4	43.0
United Kingdom	-10.2	25.0	-20.7	40.0
United States	0.0	22.5	0.0	45.9

Source: OECD (1994)

the reference date. They also assume that income levels during work and retirement are the same so pensions are not taxed at a lower rate during retirement. The marginal rate of tax on income for basic and top rate taxpayers is included in the table to show the difference between the tax treatment of income and of pension saving. Table 2 shows that the marginal rate of tax on pension saving is zero for those on average incomes in Canada, France, Germany, Luxembourg, the Netherlands, Spain, and the United States, whereas the marginal rate of tax on income is positive. This means that these countries tax pension saving as if they had a consumption tax rather than an income tax.

The marginal rates for pension saving for Australia, Austria, Ireland, Portugal, and the United Kingdom are negative. This indicates that pensions are taxed in these

countries in a regime which is more generous than a consumption tax regime. The marginal rates for pension saving in the Nordic countries and Switzerland are positive but less than the marginal rates on income so they have hybrid regimes. The marginal rates for pension saving in Belgium, Iceland, Japan, and New Zealand are positive and greater than the marginal rates for income so they have regimes which tax pension saving at higher rates than an income tax regime. This occurs because no allowance is made for inflation under an income tax regime which taxes nominal rather than real rates of return.

For top rate taxpayers the results, in terms of the type of regime used to tax pension saving, are similar but the tax incentives are much greater than for average production workers particularly in countries in which the tax treatment of pensions is more generous than a consumption tax regime (Australia, Austria, Ireland, Portugal, United Kingdom). EU countries which adopt a policy of greater reliance on private pensions for the future are, therefore, likely to provide the biggest tax incentives to taxpayers paying the highest marginal tax rates.

3. Estimates of the Cost of Pension Tax Reliefs in Ireland and the U.K.

Pension schemes in Ireland and the U.K. receive favourable tax treatment by applying to the tax authorities for "exempt approved status". To qualify for this special status a scheme must be established under an irrevocable trust, the assets of the fund must be held apart from the employer's other assets, and disposed of in accordance with a deed of trust. As none of the government agencies responsible for the operation of occupational pension schemes publish statistics on the financial operations of these schemes the tax authorities in Ireland and the U.K. have based their estimates of the cost of tax reliefs on different components of pension income flows on whatever limited information is available from different sources. Annual estimates, on a consistent basis, of the cost of the tax relief on employee contributions and of the cost of the exemption of the net income of approved funds are available for Ireland since 1980/81 and for the U.K. for occupational and other private pension plans since 1986/87[9].

For Ireland, the most comprehensive estimate of the tax expenditure on occupational pensions is the value of the tax relief on the net income of approved superannuation funds. This is based on total contributions by employers and employees plus the investment income of the funds minus the amount paid out in pension benefits and lump sums. For the U.K. Adrian Sinfield (2000, Table 1) provides estimates of the cost of tax reliefs on employee, employer, and self-employed contributions to occupational pension schemes, personal pension schemes, Free Standing Additional Voluntary Contribution schemes, Retirement Annuity Contracts, the investment income of funds, lump sum payments from unfunded schemes after deducting income tax receipts from pensions in payment and refunds to employers of pension surpluses[10].

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[9] For Ireland see Hughes (2001) and for the U.K. see Sinfield (2000)

[10] If tax reliefs for pension saving were eliminated the Exchequer would not necessarily benefit to the full extent of the value of the tax relief because of behavioural changes by savers. A similar interaction effect applies to direct public expenditure. For example, the Exchequer would not save the full cost of a social insurance pension scheme by eliminating it as behavioural changes by some beneficiaries would make them eligible for benefits under other programmes. Neither argument means

Table 3 shows the Revenue Commissioners estimates for Ireland of the cost of the tax reliefs on occupational pensions from 1980/81 to 1997/98. Over the whole period the cost of the tax relief on the net income of approved schemes rose from £30

Table 3: Revenue Commissioners Estimates of the Cost of Tax Reliefs on the Net Income of Approved Superannuation Funds in Ireland 1980/81 to 1996/97 (£ million) and Inland Revenue Estimates of the Cost of Tax Reliefs on Occupational and Other Non-State Pension Schemes in the United Kingdom 1986/87 to 1998-99 (£ million)

Year	Ireland		United Kingdom	
	Net income of occupational pension Funds £ million	Pension tax expenditure/ GDP %	Net income of private pension funds £ million	Pension tax expenditure/ GDP %
1980/81	30.0	0.32	-	-
1981/82	35.0	0.31	-	-
1982/83	40.0	0.30	-	-
1983/84	42.0	0.28	-	-
1984/85	45.0	0.27	-	-
1985/86	53.0	0.30	-	-
1986/87	62.0	0.32	6,800	1.77
1987/88	80.0	0.38	6,300	1.49
1988/89	89.0	0.39	6,800	1.44
1989/90	130.0	0.51	7,200	1.41
1990/91	200.0	0.70	7,100	1.28
1991/92	216.0	0.73	7,100	1.21
1992/93	189.0	0.60	8,000	1.32
1993/94	245.2	0.72	7,300	1.14
1994/95	344.0	0.94	10,400	1.53
1995/96	399.0	0.96	11,700	1.64
1996/97	500.0	1.09	12,100	1.60
1997/98	648.0	1.23	10,900	1.35

Sources: Ireland, Annual Report of the Revenue Commissioners 1981 to 1999; U.K., Sinfield (2000, Table 1) and HMSO (2001).

million to £648 million. Relative to GDP the cost of the favourable tax treatment of the net income of pension funds quadrupled from one-third of a percentage point in 1980 to 1.4 per cent in 1997. Table 3 also shows the cost of tax relief on occupational and personal pensions in the U.K. from 1986/87 to 1997/98. In nominal terms the cost of pensions tax relief increased from £6,800 million in 1986/87 to £10,900 million in 1997/98. However, relative to GDP the cost of the reliefs in the U.K. fell from 1.77 per cent to 1.35 per cent. A significant part of this decline is probably attributable to the abolition of Advanced Corporation Tax in the 1997 Budget. Clearly, the cost of pension tax reliefs is substantial in both Ireland and the U.K. In the U.K. it has fluctuated around 1.5 per cent of GDP since the mid-1980s while in Ireland it has increased from a relatively low level at the beginning of the 1980s to attain a similar level to that in the U.K. at the end of the 1990s.

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that the cost of tax expenditure on private pensions or direct expenditure on social insurance pensions should not be given as the full cost.

As the cost of Exchequer support for private pensions is substantial in both countries it is necessary to ask how it compares with the cost of Exchequer expenditure on public pension schemes and how tax expenditure on private pensions is distributed by income group. These questions are important because both the Irish and the British government have expressed concerns in recent years about the cost of their public pension systems and both governments have taken steps to try and contain its cost which involve greater reliance in the future on private pension provision. There is some information available from a variety of sources in Ireland and the U.K. which allow us to address these issues.

4. Tax Expenditure on Occupational Pensions and Direct Expenditure on Social Welfare Pensions

At the end of the 1980s it was realised that ageing of the population in the early decades of the 21st century would increase the cost of state pension schemes in many OECD countries. Governments began to look for ways of changing the balance between state and private pension provision in an attempt to avoid raising taxes in the future (see OECD (1992)). The British Government concluded (HMSO, 1998b) that the balance of provision should be changed over the next fifty years from 60/40 public/private to 40/60. While it projects the proportion of GDP going to pensioners to increase from 10 per cent now to about 12 per cent in 2050 such a shift is expected to reduce public expenditure on pensioners from 6 per cent to around 5 per cent of GDP and to increase private expenditure on them from 4 per cent to about 7 per cent

The Irish Government has not adopted explicit targets for state and private provision but it is broadly following a strategy recommended by the Pensions Board (1998) to gradually raise the flat-rate state pension from a quarter to a third of average industrial earnings, to accumulate a national pension reserve fund for investment in financial assets selected from global financial markets, and to try and increase pension coverage on a voluntary basis by providing access to Personal Retirement Savings Accounts[11]. The effect of these changes would be to increase total pension costs from 9 per cent of GNP in 1996 to 11 per cent in 2046 (see Pensions Board, 1998, Table 5.8). The increase would be borne by both the public and private pension systems with public pension costs increasing from 4.84 per cent of GNP to 6.24 per cent and private pension costs increasing from 4.18 per cent to 4.76 per cent of GNP. In contrast to the British government's intention to reduce the share of retirement income provided by the public pension system the outcome in Ireland is likely to be an increase in the share of retirement income provided by the public pension system with the balance of public/private provision changing somewhat from 54/46 now to 57/43 in 50 years time.

The Pensions Board (1998, p. 109) noted that "the purpose of the fund would be to place a ceiling on the additional Exchequer contribution required for [social welfare pensions for] the foreseeable future" and it recommended that the tax treatment of individual retirement savings accounts should be more favourable than

[11] The target is to increase coverage from 54 per cent of those aged 30-65 at work in 1995 to 70 per cent over a period of ten years or more.

that for occupational pension funds. Neither the British or Irish governments have provided any comparisons of past trends in Exchequer expenditure on social welfare pensions relative to tax expenditure on private pensions nor do they include in their current expenditure figures or long-term projections estimates of tax expenditure on private pensions.

The policy message which comes through the various reports published as part of the pension reviews in Ireland and Britain is that state pension schemes should be restricted to paying modest flat-rate benefits while relying on private pensions to provide more retirement income on a voluntary basis in the future. It appears to be assumed that incentives for private pension provision can be given at such little cost to the Exchequer (see Pensions Board (1997 and 1998)) that they can safely be ignored in long-term projections of pension costs. This assumption will be tested by looking at the trend in the cost of tax expenditure on occupational pensions in Ireland and on occupational and personal pensions in the U.K. relative to the trend in direct government expenditure on social welfare pensions in both countries.

Tax expenditure on occupational pensions and direct expenditure on social welfare pensions in Ireland are compared in Table 4 for the period 1980/81 to 1997/98. At the beginning of the period in 1980 tax expenditure on occupational pensions amounted to 20 per cent of direct expenditure on contributory social insurance pensions, £30 million versus £153 million. By the end of the period it had increased to 98 per cent, £648 million versus £661 million. With respect to non-contributory social assistance pensions tax expenditure increased from 21 per cent in 1980 (£30 million versus £140 million) to over 200 per cent in 1997 (£648 million versus £317 million).

In terms of the combined social welfare pension schemes the cost of tax expenditure on occupational schemes increased from 10 per cent in 1980, £30 million versus £293 million, to over 66 per cent by 1997, £648 million versus £978 million. Given the average rates of growth of tax and direct expenditure during the period 1987-97 it would only require a few more years growth at these rates for the cost of tax expenditure on occupational pensions to exceed the direct cost of expenditure on social welfare pensions. The introduction of Personal Retirement Savings Accounts (PRSA) with more favourable tax treatment than occupational pension schemes, as recommended by the Pensions Board, is likely to increase the cost of tax expenditure on pensions. One effect of implementing this recommendation may be that Exchequer support for social welfare pensions will be limited in the future while the cost of its support for private pension schemes, benefiting a much smaller number of people, will not be.

Table 4: Direct Expenditure on State Pensions, Tax Expenditure on Occupational Pensions and Direct Expenditure as Per Cent of Tax Expenditure on Pensions, Ireland 1980/81 to 1997/98

Year	Direct Expenditure on Contributory Old Age Pension & Retirement Pension	Direct Expenditure on Non-Contributory Old Age Pension	Direct Expenditure on State Pensions	Tax Expenditure on Occupational Pension Schemes	Tax Expenditure on Occ. Pensions as per cent of Direct Exp. On State Pensions
		£ million			Per cent
1980/81	153.0	140.2	293.2	30.0	10.2
1981/82	197.5	176.4	373.9	35.0	9.4
1982/83	259.3	225.0	484.3	40.0	8.3
1983/84	293.9	246.5	540.4	42.0	7.8
1984/85	325.9	264.1	590.0	45.0	7.6
1985/86	351.7	273.5	625.2	53.0	8.5
1986/87	374.5	283.9	658.4	62.0	9.4
1987/88	399.5	291.2	690.7	80.0	11.6
1988/89	417.2	291.8	709.0	89.0	12.6
1989/90	439.0	293.8	732.8	130.0	17.7
1990/91	464.9	301.5	766.4	200.0	26.1
1991/92	493.9	308.8	802.7	216.0	26.9
1992/93	529.5	317.2	846.7	189.0	22.3
1993/94	546.3	318.4	864.7	245.2	28.4
1994/95	569.0	319.1	888.1	344.0	38.7
1995/96	597.2	308.8	906.0	399.0	44.0
1996/97	626.0	310.3	936.3	500.0	53.4
1997/98	661.2	316.8	978.0	648.0	66.3

Sources:Annual Report of the Revenue Commissioners 1981 to 1999, Statistical Information on Social Welfare Services 1983 to 1997, and Special Tabulation from the Revenue Commissioners.

Tax expenditure on occupational and personal pensions and direct expenditure on National Insurance pensions in the U.K. are compared in Table 5 for the period 1986-87 to 1997-98. At the beginning of the period in 1986 tax expenditure on occupational and private pensions amounted to 39 per cent of National Insurance expenditure on the basic retirement pension, £6.8 billion versus £17.6 billion. By the end of the period it had fallen to 36 per cent, £10.9 billion versus £31.9 billion. With respect to means-tested assistance for the elderly, which consists almost entirely of income support and housing and council tax benefits, Adrian Sinfield (1997, p. 127) points out that in 1992/93 tax expenditure on private pensions “cost the taxpayer almost £2 billion more than all means-tested assistance for the poorest old people.” By 1999/00 tax expenditure on pensions was costing the taxpayer £2.5 billion more than means-tested assistance for the elderly.

Table 5: Direct Expenditure on State Pensions, Tax Expenditure on Occupational and Personal Pensions and Direct Expenditure as Per Cent of Tax Expenditure on Pensions, United Kingdom 1986-87 to 1997-98

Year	Cost of tax reliefs on net income of occupational and personal pensions £ million	Direct Expenditure on NI basic retirement pension £ million	Pension tax expenditure/NI expenditure %
1986/87	6,800	17,560	38.7
1987/88	6,300	18,356	34.3
1988/89	6,800	18,857	36.1
1989/90	7,200	20,171	35.7
1990/91	7,100	21,973	32.3
1991/92	7,100	24,451	29.0
1992/93	8,000	25,364	31.5
1993/94	7,300	26,546	27.5
1994/95	10,400	26,859	38.7
1995/96	11,700	27,740	42.2
1996/97	12,100	29,239	41.4
1997/98	10,900	30,391	35.9

Source: Sinfield (2000, Table 1) and Inland Revenue (2001a, Table 7.7)

5. Distribution of Tax Expenditure on Pensions in Ireland and the U.K.

With the reduction in both Ireland and Britain in recent years of mortgage interest relief the tax reliefs for pension funds are now the most costly items in the Revenue Commissioners and Inland Revenue lists of income tax expenditures.[12] Individual tax payers are obliged to include details on their annual income tax return of mortgage interest payments for which they are claiming tax reliefs. Consequently the Revenue Commissioners have information on the distribution of these tax reliefs by income class. Unfortunately, because of the way in which the reliefs on occupational pension contributions and pension fund income are given there is no official information on the value of the tax relief accruing by income groups for contributions to occupational pension funds. However, a household survey carried out by the ESRI in 1994 (see Callan, Nolan, Whelan, Whelan, and Williams, (1996)) contains information on weekly gross earnings of employees who are members of any type of pension scheme. These data permit us to estimate the level and distribution for Ireland of tax reliefs on contributions to occupational pension schemes by employees.

Information on the distribution of pension contribution tax relief by income group has been produced for the U.K. by Agulnik and Le Grand (1998) using unpublished data supplied by the Inland Revenue. The data for Ireland and the U.K.

[12] Structural reliefs are assumed to be part of the benchmark tax system.

are used in Table 6 to show by income deciles the percentage of employees in Ireland who belong to an occupational pension scheme and the percentage of taxpayers in the U.K. who claim tax relief on contributions to an occupational or personal pension scheme.

Table 6: Percentage of Employees in Ireland in 1994 Belonging to Occupational Pension Schemes and Percentage of Taxpayers in the U.K. in 1996-97 Claiming Tax Relief for Contributions to an Occupational or Personal Pension Ranked by Income Deciles

Decile	Ireland	United Kingdom
Bottom	0.5	20.8
Second	8.9	25.7
Third	16.5	26.3
Fourth	35.6	37.7
Fifth	50.1	48.4
Sixth	59.7	56.3
Seventh	70.5	61.8
Eighth	79.4	68.2
Ninth	89.0	78.8
Top	92.7	80.7

Source: Ireland, Hughes (2000, Table 8); U.K., derived from Agulnik and Le Grand (1998, Table A1.)

The table shows that coverage of occupational pension schemes is quite good for the top three deciles in both countries; reasonably good for middle income employees in the fifth, sixth, and seventh deciles with from around 50 to 70 per cent having a pension entitlement; rather poor for low income employees in the U.K. for the bottom, second, third, and fourth deciles with only 20 to 40 per cent having an entitlement, and very poor for the lowest income deciles in Ireland with virtually no occupational pension coverage for the bottom income decile and only 10 to 35 per cent being covered in the second to fourth deciles[13]. The differences between Ireland and U.K. are most pronounced towards the bottom and top of the earnings distribution. The difference for the lowest income deciles may be partly due to the fairly uniform take-up by income decile of personal pensions in the U.K.

The only data available to assess the distribution of tax support in Ireland for occupational pensions come from the ESRI Living in Ireland survey. It contains information on the size of the employee contribution to occupational pension schemes but unfortunately not on the employer contribution. An estimate of the value of the tax relief given to employees can be derived by income class which will show whether the tax support provided for employee contributions is progressive, proportional, or regressive relative to income. The estimates of the value of the tax expenditure as a percentage of income take account of marital status, the standard personal allowances, and the relevant marginal tax rates. The aggregate value of pension contributions and of the tax relief are averaged across everyone in the income class whether they make a pension contribution or not. Data are available from the Inland Revenue for the U.K. on the distribution by income group of employees'

[13] The pattern is similar in Ireland when pension coverage rates are estimated by age group. For example, the coverage rate for those under 30 was 1.3 per cent for the first decile and 79 per cent for the 10th decile.

contribution relief for occupational and personal pensions and Agulnik and Le Grand (1998) gross up employees' contributions to estimate the value of tax relief on employers' contributions. Lack of data for Ireland and the U.K. preclude estimates of the distributional effect of tax reliefs on lump sums or investment income. Table 7 shows that tax support for private pension contributions is regressive in both Ireland and the U.K.

Table 7: Tax Relief on Employee Contributions to Occupational Pension Schemes in Ireland in 1994 and on Employee and Employer Contributions to Private Pension Plans in the U.K. in 1996-97 as a Percentage of Income by Income Decile

Income Decile	Ireland (Employee Contribution)	United Kingdom (Employee and Employer Contributions to Occupational and Person Pensions)
Bottom	0.06	0.71
2	0.11	0.80
3	0.18	0.83
4	0.41	1.33
5	0.76	1.39
6	0.79	1.59
7	0.85	1.69
8	1.23	1.82
9	1.72	2.29
Top	1.62	3.64

Source: Ireland, Hughes (2000, Table 8); U.K., derived from Agulnik and Le Grand (1998, Table A1.)
Note: These figures do not include the value of tax reliefs on lump sum payments or investment income.

The value of the relief on employee contributions alone in Ireland expressed as a percentage of weekly income increases from less than 0.06 per cent at the bottom of the income distribution to around 0.8 per cent in the middle and to about 1.6 per cent at the top. Thus, those on the lowest incomes, less than IR£41.00 per week, receive hardly any benefit from the tax relief on occupational pension contributions while those on the highest incomes, over IR£720 per week, benefit to the extent of 1.6 per cent of their weekly income. For the U.K. the value of tax relief on both employee and employer contributions as a percentage of income rises from 0.71 per cent for those in the bottom income decile earning less than Stg £90 per week to 3.6 per cent for those in the top income decile earning almost Stg £870 per week on average. Of this tax relief, Table 8 shows that the top 10 per cent of earners in Ireland receive almost 40 per cent of the benefit while in the U.K. they receive over 50 per cent of the benefit. In Ireland the bottom 10 per cent of earners receive only 0.1 per cent of the tax benefit while in the U.K. they receive just 1 per cent of the tax benefit.

There are two main reasons for the regressivity of tax expenditure on private pensions, as Le Grand and Agulnik (1998) point out. The first is that membership of occupational pension schemes increases strongly with income, as we have shown above. The second is that the tax relief is given at the marginal rate of tax. Hence, the value of the tax relief as a percentage of income rises as income rises. The

interaction of these two factors results in a steady increase in the absolute value of the tax relief on occupational pension contributions as the absolute value of income rises.

Table 8: Distribution of Tax Relief on Employee Contributions to Occupational Pension Schemes in Ireland in 1994 and on Employee and Employer Contributions to Private Pension Plans in the U.K. in 1996-97 by Income Decile

Income Decile	Ireland (Employee Contribution)	United Kingdom (Employee and Employer Contributions to Occupational and Person Pensions)
Bottom	0.1	1.0
2	0.4	1.3
3	0.8	1.2
4	2.5	3.9
5	5.4	4.5
6	6.5	5.3
7	8.3	8.1
8	13.9	7.5
9	24.0	15.6
Top	38.0	51.6
Total	100.0	100.0

Source: Ireland, Hughes (2000, Table 8); U.K., derived from Agulnik and Le Grand (1998, Table A1.)
Note: These figures do not include the value of tax reliefs on lump sum payments or investment income.

The concentration of pension tax expenditures in Ireland and the U.K. on the highest paid taxpayers is a striking example of the 'upside-down' nature of tax expenditures whereby, as Sinfield (1997, p. 20) notes:

> "The benefit is greater, the higher the income and the higher the marginal tax rate which is avoided as a result of the tax mechanism. The greatest beneficiaries are those who have the least needs by any measure used in social policy analysis."

6. Summary and Conclusions

The evidence presented in this paper shows that the annual cost of tax expenditure on pensions is substantial in Ireland, where it amounted to 1.2 per cent of GDP in 1997, and the U.K., where it was not far off 1.5 per cent of GDP in the same year. Hence, the assumption that private pensions can be provided at little cost to the Exchequer is not correct. Considering pension tax expenditure in relation to direct expenditure on public pension programmes the evidence shows that tax expenditure in Ireland on occupational pensions now substantially exceeds the cost of the means-tested non-contributory pension scheme and amounts to about two-thirds of government expenditure on social insurance pension schemes. If present trends in pension tax expenditure continue, it may exceed in a few years time combined expenditure on social assistance and social insurance old age pensions. In the U.K. the cost of pension tax reliefs substantially exceeds the cost of means-tested income and housing support for the elderly and amounts to about one-third of direct expenditure on basic National Retirement pensions.

Examination of membership of private pension schemes shows that tax incentives for pension saving result in high coverage rates for middle and high income taxpayers but poor coverage rates for low income taxpayers in both Ireland and the U.K. Evidence relating to the distribution of pension tax expenditure shows that the present tax treatment of private pensions is inequitable as about two-thirds of the benefits accrue to the top two income deciles in both countries and 3 per cent or less to the bottom two deciles.

PENSIM, the microsimulation model of the U.K. pension system, was used by the Pension Provision Group at the start of the British government's latest Pension Review to look at the effect of current policies on pension provision in 2025. The Group examined how the distribution of pension incomes is likely to change over this period. It concluded (HMSO, 1998a, p. 109) that:

> The bigger role for earnings-related pensions – state and non-state – which has been a feature of the policy of governments for several decades, must inevitably lead to more inequality in income in old age.

The pattern of pension provision in Ireland in the future is likely to be similar in view of the reliance on occupational pension schemes and the concentration of tax reliefs for pension saving on the highest income deciles.

Proposals for containing the cost of public pension systems in Europe by relying on greater private pension provision in the future can learn from experience in Ireland and Britain, and other countries that rely on private pensions, that using tax incentives to promote private pension provision could impose substantial costs on the Exchequer. The regressive nature of such incentives means that all taxpayers have to pay more taxes to provide benefits which accrue overwhelmingly to higher income taxpayers.

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