

## Who Really Benefits from Tax Relief?

*We often hear the argument made that tax relief on pension contributions favours the wealthy and that it would make more sense to abolish these and use the money saved by the Exchequer to increase the State pension. The argument usually runs along the line that expenditure on Social Welfare pensions was €3.6 billion in 2006 whereas the “cost” of tax relief estimated in the Green Paper for 2006 was €2.9 billion. Therefore this €2.9 billion could be used to provide a substantial increase to Social Welfare pensions and everyone is better off.*

and diverting the current cost into providing a higher State pension is “fundamentally unsound” according to Life Strategies. “Analysis to date in this area has been overly simplistic and the suggestion that reduced tax relief on pensions contributions could fund a higher State pension does not stand up to proper economic scrutiny once you look beyond year one,” commented Michael Culligan, Director, Life Strategies.

The Life Strategies report finds that extreme proposals are fundamentally flawed on grounds of sustainability and relativity. Projections show that the strategy of diverting approximately €2 billion of funding (even if this could be diverted) could increase the State pension from 34% of average earnings to 50%. However, this proposition is fundamentally unsustainable as, “although cost-neutral in the current year, it would result in a substantial worsening of the overall budgetary position as the population ages”.

“In summary, it would result in a net additional cost of over 2% of GNP by the middle of the century”, states the report. This is in addition to the already projected increase in State Pensions expenditure from its current level of roughly 3% of GNP to in excess of 10% of GNP by the middle of the century. On the other hand, projections indicate that the net cost to the Exchequer of supporting the supplementary pension system through tax reliefs will remain stable at close to its current level.

The study also analyses the ‘net effective rate’ of tax relief on pension contributions and compares it to the ‘headline rate’. It finds that for high earners the net effective rate of relief is lower than the headline rate, reflecting the fact that tax will be paid on the pension in retirement. It also concludes that the net effective rate of relief falls as people move up the income band. Those who do best, in terms of having the highest net effective rate of relief are those with earnings of €45,000.

“We find that the current system gives the highest benefit to those earning just above the average industrial wage and that the benefit falls as one moves up the earnings scale and/or as one increases the level of pension contributions,” commented Michael Culligan. “This is a little remarked but desirable feature of the current system.”

The study also highlights the knock on effects on the cost of public sector pensions if tax reliefs are reduced. It estimates that the total employer and employee contributions to public sector pensions if funded would be in excess of €3 billion per annum. In order to ensure equitable treatment of private and public sector scheme members, any move to reduce or remove tax reliefs on private sector arrangements would also need to be mirrored in the public sector. This would have to be done by imposing a benefit in kind tax on the notional employer contribution with public sector employee contributions falling to be made from salary after tax.

The IAPF has always had a number of concerns about this argument being too simplistic and not addressing some fundamental issues. We felt it was important to address this in our response to the Green Paper and commissioned Life Strategies to conduct some independent research on this issue. The completed report formed part of our Green Paper response and, more importantly, provides an important contribution to the overall debate.

The economic case for reducing or eliminating the tax incentivisation of pensions