The Taxation of Pensions and Tax Reform in Ireland

Jim Stewart

Pension Policy Research Group, TCD

- There are two main areas we would like to address this evening:
- (1) Tax expenditures – The cost of Pension Tax reliefs
- (2) Proposals in the National Pensions Framework Document

1. Tax Expenditures

- Our starting point for any discussion of the costs, effects, benefits of the taxation of pension provision is the OECD definition of a tax expenditure (Quoted in Commission on Taxation, 2009, p. 238).

  “A transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by direct expenditure”.

- This is a widely used and accepted measure of tax expenditures. As such the estimates of tax relief in the Green Paper are logically based.

Tax Expenditures

- We have what is commonly referred to as an EET system of pension taxation.

1. Contributions are exempt from tax
2. The accruing fund is not subject to tax
3. Tax is paid on the draw down of the fund via for example, an annuity

- The resulting tax savings are valuable (1 + 2 -3) as shown in the Green Paper (Table 7.2)

Tax Expenditures

The Irish Association of pension Funds have stated (Fact Sheet, 1998);

"It is a common misconception that pension funds are exempt from tax.. .. they actually operate on the basis of deferred taxation Not no taxation,.. 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"

Tax Expenditures

- The previous speaker repeats this point where he has stated under an EET system:-
- “The money is not taxed when it is earned but when it is spent in providing the recipient with funds in retirement….. this aspect of pension treatment has been used correctly to point to the fact that when an income tax approach is used in considering pension taxation the tax apparently “lost” is not lost at all but is payable at a later date”. (McDowell, The Tax Treatment of Pensions, p. 21) .

Tax Expenditures

- These arguments are puzzling especially when made by those working in the pensions industry, because advertising to contribute to a pensions scheme frequently emphasises tax savings.

- If there are in fact no savings does this make such claims liable to compensation because of misselling through false advertising?

- I think not, because tax reliefs for pension contributions are valuable and indeed for many have been the main if not the only source of returns given stock market falls.

Tax Expenditures

- Indeed the Society of Actuaries submission to the Green Paper (appendix 3, p. 4) concludes “that the current system does entail significant effective rates of tax relief”.

- Although some tax reliefs would appear to be omitted in their analysis, for example the tax exemptions on the accruing fund.

Tax Expenditures

- The submission states (appendix 3, p. 2) :- “The Society has estimated the overall effective rate of tax relief on lifetime pension savings, allowing for the tax relief on savings and the tax payable on pension income in retirement.. .. ..”
- Munnell (National Tax Journal 1991, p. 395) specifically states that tax reliefs on the accruing lump sum must be included in estimating tax expenditures associated with pension provision.
- Conclusion: Tax expenditures are high, are of value, and mostly benefit high income earners.

The current tax regime for pensions

- EET and TEE pension tax regimes under certain strong assumptions, are equivalent to an expenditure tax as in the public finance literature (Whitehouse p. 7 and others).
- This means one of the classical canons of taxation is satisfied – it is neutral between consumption now and in retirement.
- One question that arises even if achievable is this desirable? These issues are lucidly discussed in the Report of the Commission on Taxation (1982, pp. 83-86).
- However it is important to recognise that under our income tax based system, tax expenditures must include the middle 'E'

The current tax regime for pensions

- Whitehouse also comments that EET and TEE systems may not have the same effect because of different marginal rates of tax paid while at work, versus in retirement (Whitehouse p. 6).

- The current tax regimes for pensions in Ireland has further exacerbated the difference so that the OECD recently concluded that rather than an EET system we have an EEE system because of double PAYE allowances for married couple, failure to annuitise, tax free lump sum. etc.

What Kind of Tax Regime is proposed?

- The Framework document proposes a number of changes to the tax regime for pensions. Some of these we support:-
- (1) The proposal to grant tax reliefs at a reduced rate, but we advocated relief at the standard rate, not 30% as originally stated in the revised agreement for Government nor the 33% rate subsequently announced.
- (2) Changes in the taxation of the lump sum. The Commission on Taxation recommended that the exemption from taxation should apply to sums below €200,000 and this was included in the 2010 budget. We advocated a lower exemption level.

The current tax regime for pensions

- (3) The tax treatment of those with individual pension arrangements will be simplified. Certain aspects of individual pension arrangements result in the greatest inequities in our pension system.
- The Department of Finance found that there were about 6000 Approved Retirement Funds in 2006 with total investment value of €1,340 million - an average value of €235,000, compared with an average PRSA value in Dec 2008 of €7700. Two funds had over €100 million at retirement, nearly four times larger than in the Fingleton/INBS case.
- Restrictions introduced on the size of the tax relieved lump sum do not apply to lump sums accrued prior to 2005.

The Problem with a tax driven model

- One reason for the crisis in pension provision is because of the excessive investment in high risk assets.

- Society of Actuaries Submission to Green Paper, (4.1) states:

- “The current system over-promises and under-funds and scheme members are exposed to far greater risks than are commonly understood”.

The Problem with a tax driven model

- Why was so much invested in equities? This was partly because of a false belief in the equity risk premium, but also because of commission driven selling.

- Equity products attract higher commissions. The marketing drive was to emphasise tax reliefs, but then valuable tax reliefs allowed higher charges. The net effect is that tax reliefs were ‘shared’ between the industry and the individual.

Will savings be Reduced as a result of tax changes?

- In a study of the relationship between pension saving and national saving Hughes found that “there was no significant difference,.. in national savings rates between countries which have funded occupational schemes and countries which do not”.

- (Hughes “Pension Financing, the Substitution Effect and National Savings” in Hughes and Stewart (Eds.) Pensions in the European Union: Adapting to Economic and Social Change, Kluwer, 2000).

Will savings be Reduced as a result of tax changes?

- We should also note:-
- Scheme membership is usually a condition of employment and many of those in occupational pensions have no choice in relation to pension contributions.
- Wealthy individuals may choose to save in an alternative tax based system so that while ‘pension savings’ may fall overall savings of this group are unlikely to be affected.

The Proposed New Individual Pension Scheme

- The Proposed New Individual Scheme will not work because of:-

- (1) Affordability;
- (2) low contribution rates;
- (3) It will be costly;
- (4) Added complexity- multiple sources of small amounts of pension income;
- (5) Result in gaming the system, pay funds in before retirement for immediate draw down post retirement.

The Proposed New Individual Pension Scheme

- The UK experience. One expert opinion:-
- “The United Kingdom has now had individualised pension provision for two decades; the current government has announced its intention to continue and extend this form of provision even though there is no substantial evidence that such individualised provision has improved or will improve the pension entitlements of a substantial proportion of scheme participants. Indeed evidence suggests the contrary”. (Barbara Waine in Stewart and Hughes eds. 2009)

The State pension

- We welcome the commitment in the Framework document (p. 15) that the “State pension is the fundamental basis of the pensions system” and the policy statement that “it is important to ensure that those qualifying have made a sustained contribution to the Social Insurance Fund (SIF) over their working lives (p. 19).
- This latter policy would appear to contradict the proposal that “a new universal social contribution will replace employee PRSI, the Health Levy and the Income Levy”.

Increasing the Retirement Age

- Given that life expectancy is related to income and social class increasing the retirement age could be redistributive, that is from poorer to more wealthy individuals.

- This issue needs to be recognised and addressed by the proposed implementation group. There are considerable savings from extending the retirement age (Kathleen Barrington, Sunday Business Post, March 7, 2010).

- These savings need to be properly estimated, and reviewed in the light of the likely regressive nature of extending the retirement age.

Increasing the Retirement Age

- It is interesting to note the views of the Society of Actuaries in relation to raising the retirement age:
- That there should be a minimum notice of 15 years;
- That there should be early and late pension payment options;
- That the State pension should be paid once a contribution threshold has been reached (because of the regressive effects of increasing the State pension age).

Conclusion

- Occupational pensions will always be part of the pension system in Ireland.
- We advocate reform of the existing system. In advocating reform we are mindful of the path dependent nature of pension systems.
- Changing pension systems imposes large costs on all participants – the industry, members of pension schemes, those in retirement and the State.
- We should learn from the UK. The variety of different sources of pension income to those in retirement has led to large administrative and other costs and the pensions missselling scandal

Conclusion

- Tax reliefs are a major part of our pension system.

- They have not succeeded in increasing national savings, or in significantly increasing the coverage rate over the last twenty years.

- What they have achieved is to change the form in which savings are made. Pension tax incentives have encouraged individuals to save via financial assets, often outside Ireland, rather than invest in assets in Ireland that may create/sustain jobs and increase the productive potential of the economy on which ultimately all pensions are based

Conclusion

- The future of the Pensions industry is to develop financial products and services that are of value.
- A focus on tax minimisation goes hand in hand with commission driven selling as the benefits of tax reliefs are split between the individual and the industry.
- They are at best a distraction and at worst become an aim in itself, loosing sight of what should be the focus – innovation, new products, competing effectively, and delivering value for money to customers.