Analysis of tax aspects of Irish pension provision

Research for the Irish Association of Pension Funds

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Research request

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- View expressed that tax reliefs should be diverted to finance a considerable increase in level of State Pension

- IAPF concerns:
  - that the cost of the tax relief is difficult to estimate precisely and may be subject to significant variability from year to year;
  - that the cost of the tax relief may not be readily transferable to the State ("Pillar 1") system;
  - that the "cost" of the tax relief is really tax deferred rather than tax foregone, and that any analysis needs to recognise and quantify this point;
  - that the argument for an increase in the level of the State Pension cannot be made solely on the basis of the current cost: one also needs to look at the longer-term implications.

Our work

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- Life Strategies was engaged to:
  - Analyse and critique the estimates of the cost of tax relief and its transferability to support the State pension
  - Model and project the cost implications of diverting tax reliefs to increase the State pension
  - Prepare a report setting out our findings

Agenda

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1. **Analyse & critique Green Paper estimate of cost of tax reliefs**

2. **Model the long-term cost implications of diverting tax reliefs to increase the State pension**

3. **Analyse the impact of tax deferral on true cost of reliefs**

Estimate of cost of tax reliefs

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- Green Paper contains an estimate of €2.9 billion for the current (2006) cost of tax and other reliefs, made up as follows:

	Green Paper € millions
Reliefs on contributions	1,890
Cost of tax-free lump sums	130
Tax foregone on investment earnings	1,200
Total gross cost	**3,220**
Tax revenues from pensions in payment	(320)
Total net cost	**2,900**

Estimate of reliefs on contributions

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- Let's focus first on the total figure for reliefs on contributions (€1,890m)

	Green Paper € millions
Tax relief on employee contributions	540
Tax relief on employer contributions	120
Exemption of 'er contributions from 'ee BIK	510
Tax relief on contributions to RACs	380
Tax relief on contributions to PRSAs	120
PRSI and health levy relief on contributions	220
Total reliefs on contributions	**1,890**

Shouldn't count 12.5% corporation tax relief if also counting BIK

- Lines up very closely with our previous independent estimate
  - But includes double count of employer contributions

What about public service pensions?

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- Green Paper includes a figure of €510m for cost of not treating employer contributions as a benefit for BIK purposes
  - In other words if this exemption were abolished, employees would have to pay €510m in BIK on the contributions made by their employers on their behalf
- However, because (most) public sector schemes are not pre-funded and hence the State does not make actual employer contributions to a pension fund, the Green Paper figure makes no allowance for the BIK liability for public service employees
- Based on our Benchmarking work, we estimate the equivalent notional employer contribution as approximately €2.7 billion
  - So, for consistency, any estimate of the BIK foregone on employer contributions should include this
  - This would add over €1 billion to the overall estimate of the total BIK liability

Tax foregone on investment returns

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- Tax foregone from exemption of investment returns is by far the single largest cost item

- In our view the estimate in the Green Paper is too high
  - Green Paper figure based on 7.50% net return
  - Our work suggests that 5.75% might be more appropriate (based on reasonable allowance for equity risk premium and low inflation)
  - Reducing from 7.50% to 5.75% would reduce this figure by €280m

- Green Paper makes no allowance for or reference to potential volatility of this figure from year to year

Estimate of cost of tax reliefs

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- Making adjustments for the double-count of employer contributions and the high investment return assumption reduces the estimate of the overall cost by €400m

	Green Paper € millions	Our estimate € millions
Reliefs on contributions	1,890	1,770
Cost of tax-free lump sums	130	130
Tax foregone on investment earnings	1,200	920
Total gross cost	**3,220**	**2,820**
Tax revenues from pensions in payment	(320)	(320)
Total net cost	**2,900**	**2,500**

Other important points

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- ‘Apples and oranges’ approach
  - Costs are based on current pre-retiree population
  - But offset for tax take is based on current pensioner population (inappropriate given the immaturity of the Irish system)
  - This is an unsound approach to allowing for the impact of tax deferral
  - Will return to measuring the impact of tax deferral later

- Removing all these tax reliefs would move the Irish system from an EET system to a TTE (or TTT?) system
  - Contributions from Taxed income; Tax on investment earnings; Exempt (or Taxed?) pensions
  - This would fly in the face of EU policy in this area:
    - *“EET approach is the preferred system from the point of view of the European Commission”* (Source: Section 7.3 of the Green Paper)

Transferability of tax savings?

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- Not all tax reliefs can be expected to be transferable to support an increase in the State Pension
- On the face of it, removing reliefs on contributions would bring in some €1.8 billion in additional tax revenues
  - Or, approximately €3 billion if we include public sector BIK
- However, in our view, a large proportion of the apparent savings from the abolition of tax reliefs on contributions may not materialise
  - Self-employed, in particular, could be expected to reduce pension contributions and seek alternative tax mitigation strategies
- When it comes to taxing investment returns:
  - Estimate €0.9 billion in additional revenue on average but would be extremely volatile and couldn't budget with any certainty in advance
  - Average pension managed funds have returned from -20% to +20% p.a. in last decade
  - Would it be politically acceptable to impose a retrospective tax?

Recap to date

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- Green Paper includes an estimate of €2.9 billion for current cost of tax and other reliefs
- We think that this is somewhat overstated and suggest that €2.5 billion might be a better estimate using their methodology
- However, we take issue with their methodology when it comes to allowing for the tax revenues which are derived from pensions in payment
- We also note that BIK on public sector employer contributions is ignored
- We note that removing exemptions & imposing taxes would move us away from our current EET system which is the EU's preferred model
- We question whether the full estimate of tax savings would actually materialise in practice and we note the volatility of the investment return component (and whether it could/should be taxed)

Agenda

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1. Analyse & critique Green Paper estimate of cost of tax reliefs

2. **Model the long-term cost implications of diverting tax reliefs to increase the State pension**

3. Analyse the impact of tax deferral on true cost of reliefs

Projected State Pension costs

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- Proposition that the existing reliefs should be removed or significantly curtailed with the savings being used to finance an increase in the State Pension
- Before looking at the long-term implications of this strategy, let's look first at the projections for the cost of the State Pension as it currently exists

	2006	2016	2026	2036	2046	2056
Cost (% GNP)	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%

- These figures (taken from our work for the Pensions Board in the context of the NPR) show a more than three-fold increase over the coming half century
  - Findings are broadly consistent with recent work by others (e.g. Dept. of Finance; Actuarial Review of Social Insurance Fund)
- Very large increase in PRSI required (+74%) to fund current system as is
  - According to Actuarial Review of SIF

Projected cost of tax incentives

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- On the other hand, looking at the cost of incentivising voluntary pension provision our projections indicate that the net cost is set to remain fairly stable
  - Taken from our NPR work for the Pensions Board
  - Gross cost increases but so to does projected tax take from pensions in payment as demographics change and population ages

	2006	2016	2026	2036	2046	2056
Relief on contributions	1.4%	1.5%	1.5%	1.4%	1.3%	1.3%
Tax foregone on inv. inc.	0.4%	0.5%	0.6%	0.7%	0.7%	0.7%
Tax revenues (pensions)	(0.2%)	(0.2%)	(0.3%)	(0.4%)	(0.6%)	(0.6%)
Net cost	**1.6%**	**1.8%**	**1.8%**	**1.7%**	**1.4%**	**1.4%**

Projected net Exchequer costs

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- Table shows projected development of overall net Exchequer cost
  - Taking State Pension and Pillar 2 cost from earlier slides
  - And adding PRSI receipts (current rates), NPRF and public service pensions

	2006	2016	2026	2036	2046	2056
Pillar 1	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
Public service	1.0%	1.6%	2.2%	2.6%	2.8%	2.9%
PRSI	-3.7%	-3.7%	-3.7%	-3.7%	-3.7%	-3.7%
NPRF	1.0%	1.0%	0.7%	-0.9%	-2.7%	-3.5%
Pillar 2	1.6%	1.8%	1.8%	1.7%	1.4%	1.4%
Net cost	**2.9%**	**4.4%**	**5.9%**	**6.2%**	**6.5%**	**7.2%**

- Overall picture is one of steadily increasing net Exchequer cost
  - But with projected cost of Pillar 2 tax incentives broadly stable over time

How much could the State Pension increase by?

- State Pension (Contributory) is currently at a level of c. 34% of gross average industrial earnings (GAIE)
- Pensions of €3.68 billion paid from Social Insurance Fund in 2006
- NPR Report indicates that total State Pension spend in 2006 was c. €4.5 billion
  - Includes non-contributory pensions which are not paid from the SIF
- We saw earlier that cost of tax reliefs for 2006 was estimated at €2.5 billion, but not all directly transferable
  - Could also argue for addition of public service BIK and no change to tax exemption of investment returns
- If we say that €2 billion is available to transfer to fund an increase the State Pension, then this would allow us to increase the State Pension to 50% of GAIE (34% x 6.5 / 4.5 = 49%)
- So, on this basis we could increase the State Pension to 50% of GAIE at no additional net cost to the Exchequer <u>in the current year</u>

Implications of increasing State Pension to 50% of GAIE

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- Need to compare projected future extra cost of increased State Pension with projected future savings from abolition of tax incentives
- First look at projected implications of increasing State Pension to 50% of GAIE

	2006	2016	2026	2036	2046	2056
34% GAIE	3.0%	3.7%	4.9%	6.5%	8.7%	10.1%
50% GAIE	4.4%	5.4%	7.2%	9.5%	12.8%	14.8%
Extra spend	**1.4%**	**1.7%**	**2.3%**	**3.0%**	**4.1%**	**4.7%**
Extra tax revenues	(0.3%)	(0.3%)	(0.5%)	(0.6%)	(0.8%)	(0.9%)
Net extra cost	**1.1%**	**1.4%**	**1.8%**	**2.4%**	**3.3%**	**3.8%**

Projected savings from removal of tax reliefs

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- Combining the projected additional spend on State Pensions with the projected savings from abolishing tax reliefs on supplementary pensions gives the following results:

	2006	2016	2026	2036	2046	2056
Pillar 1 increase	1.1%	1.4%	1.8%	2.4%	3.3%	3.8%
Pillar 2 saving	1.4%	1.6%	1.6%	1.6%	1.3%	1.4%
Net saving	**0.3%**	**0.2%**	**(0.2%)**	**(0.8%)**	**(2.0%)**	**(2.4%)**

- **Conclusion: This strategy would lead to a marginal net saving in the early years but would add substantially to the long-term sustainability and affordability of the State Pension system**

Equivalent to c.€3.7bn in today's terms

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Impact of tax deferral

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- Tax reliefs or tax incentives to encourage supplementary pension provision are not a “cost” in the true sense of the word
  - in that they represent tax deferred rather than tax foregone

- True cost of tax reliefs cannot be measured simply by looking at the rate of relief obtained on contributions
  - also needs to take account of the tax paid in the future as a result of having made those contributions

- Concept of “net effective rate of tax”
  - Indebted to work by Society of Actuaries in Ireland for this concept
  - Allow for cost of tax reliefs granted on contributions
  - But deduct tax revenues which will come from resulting pension
  - Captures tax revenues which will accrue in future in return for reliefs granted - better measure than the “headline” rate of relief

Net effective rate – Example 1

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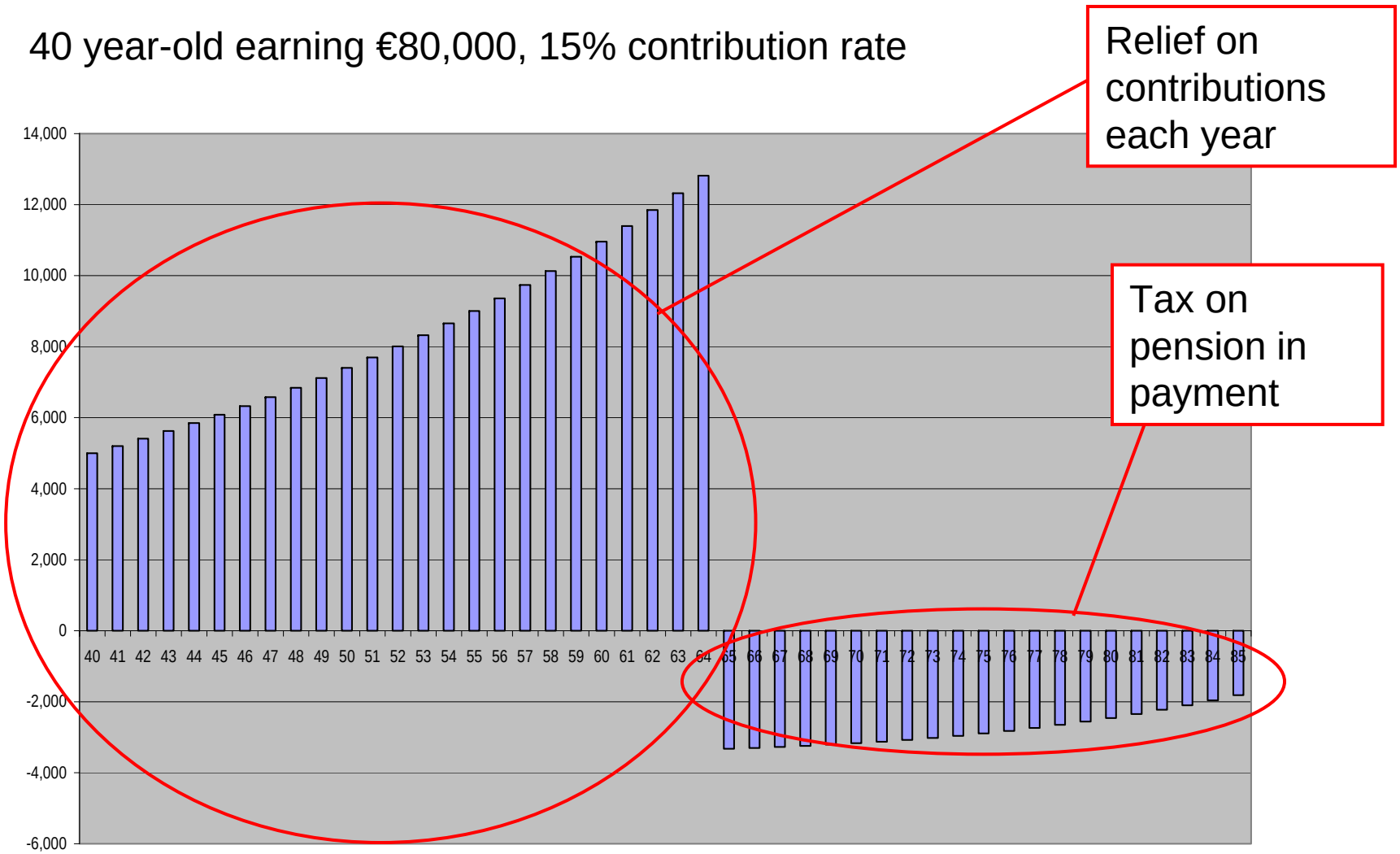
- 40 year-old earning €80,000, 15% contribution rate



Net effective rate – Example 2

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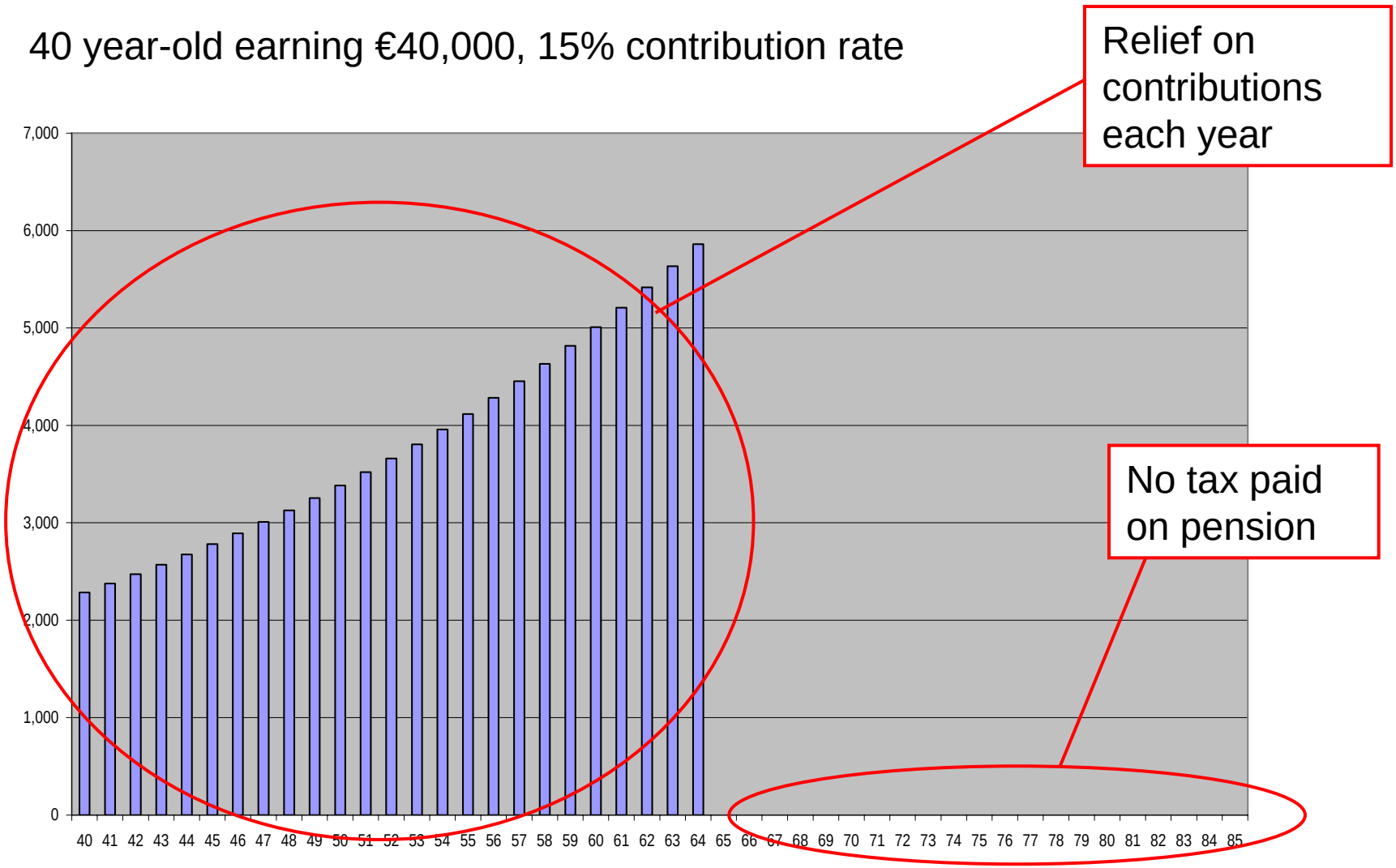
- 40 year-old earning €40,000, 15% contribution rate



Net effective rate – summary

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- Project stream of future tax reliefs
- Project stream of future tax revenues
  - May be zero if pension is low
- The difference between the two is the stream of “net tax reliefs”
  - As in example on previous slides

- Reliefs and revenues occur at different times, so we need to allow for the time value of money
  - Place a capital value (present value) on this stream of “net reliefs”
  - Place a capital value on the contributions

- “Net effective rate of relief” % = $\frac{\text{Capital value of net reliefs}}{\text{Capital value of contributions}}$

Net effective rate – findings

- Combining the projected additional spend on State Pensions with the projected savings from abolishing tax reliefs on supplementary pensions gives the following results:

Salary	Headline rate	Net effective rate
25,000	22.0%	22.0%
30,000	22.0%	22.0%
40,000	38.1%	38.1%
50,000	43.0%	42.8%
75,000	41.7%	37.2%
100,000	41.7%	34.1%
150,000	41.7%	30.4%

Highest for those earning c. 45,000.

Falls a little above PRSI cut-off.

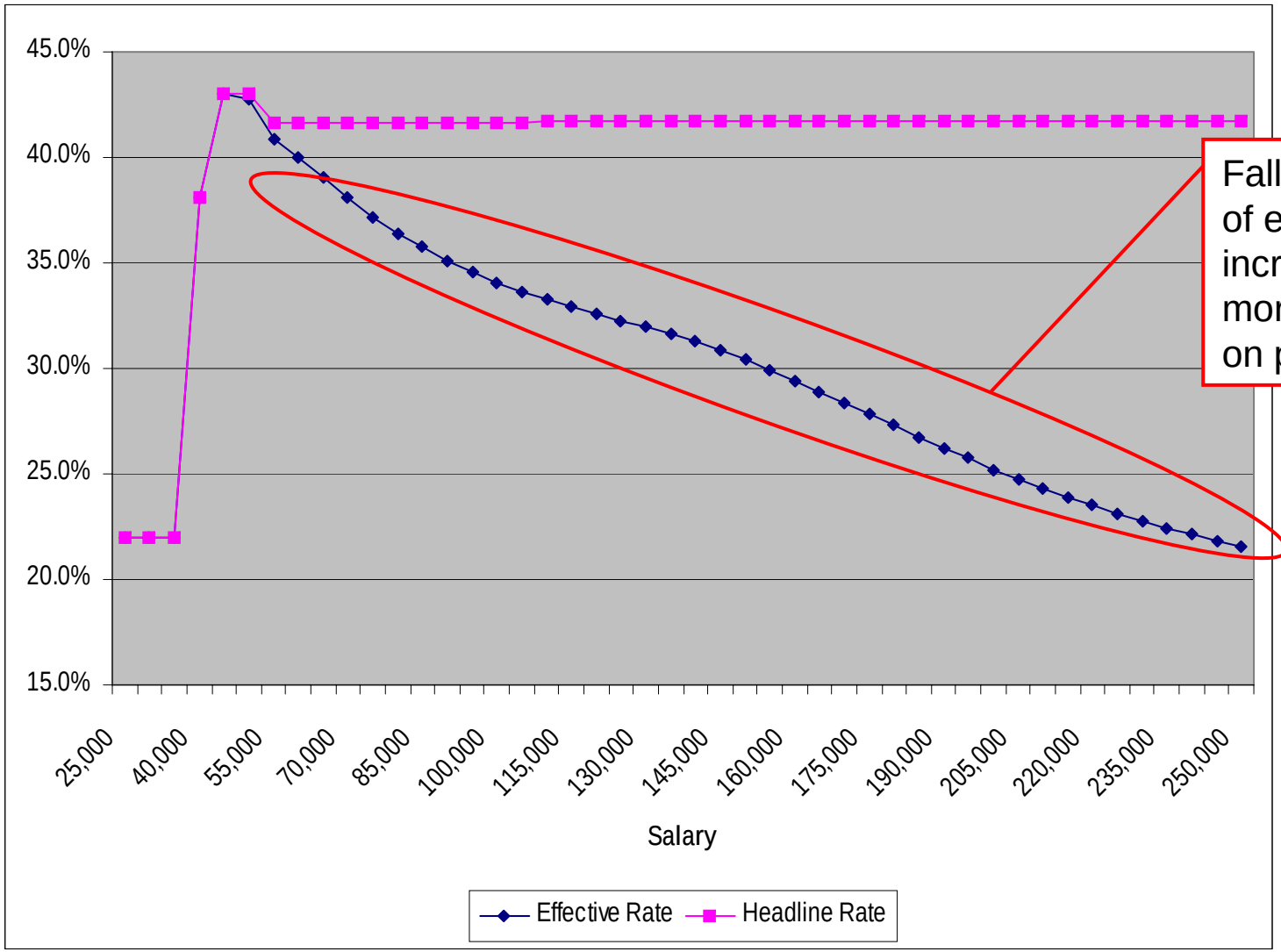
Constant thereafter.

Highest for those earning c. €45,000

Falls as salary increases further (as higher taxes paid on pension in retirement)

- **Example based on 40 year-old, 5% employee contribution, 10% employer contribution**

Net effective rate – findings



Conclusions

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- Net effective rate is a better measure of the true cost of tax reliefs as it allows for the tax revenues that will accrue in the future
- Higher contributions give rise to higher pensions (on average)
- Therefore:
  - For a given rate of contribution, the net effective rate falls as the level of earnings increases
  - For a given level of earnings, the net effective rate falls as the level of contributions increases
- Both of these would seem to be desirable – but seldom commented on – features of the current system of tax reliefs

Agenda

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Summary and conclusions

Conclusions (1)

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- Green Paper estimate of €2.9 billion for current cost of tax and other reliefs
- Our views:
  - Double counts employer reliefs
  - Puts too high an estimate on the tax yield from taxing investment returns
  - 'Apples and oranges' approach to allowing for tax revenues from pensions
  - Note that BIK on public sector employer contributions is ignored
- Removing exemptions on contributions & imposing taxes on investment earnings would move us away from our current EET system (which is the EU's preferred model)
- Question as to whether the full estimate of tax savings would actually materialise in practice
  - Behavioural impact on contributions
  - Volatility of the investment return component (and whether it could/should be taxed)

Conclusions (2)

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- State Pension system is unsustainable in its current form
  - Costs projected to more than treble over next 50 years (from 3% of GNP to over 10% of GNP)
  - Not just our view – similar findings from other recent studies

- Increasing the State Pension (funded by abolishing reliefs) would increase its unsustainability
  - Diverting current tax relief savings of €2bn would allow State Pension to be raised from 34% to 50% of GAIE at no additional current year cost
  - But, population ageing means that increasing the State Pension exacerbates the long-term affordability issues

Conclusions (3)

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- The tax reliefs granted to the Pillar 2 system will not deliver the resources required to fund the increase in the State Pension
- We project the net cost to the Exchequer of tax reliefs on Pillar 2 as relatively low and constant over time
  - Net cost (i.e. tax reliefs on contributions plus tax exemption on investment return less tax received from pensions in payment) is projected to remain relatively stable in 1% to 2% of GNP range
- Contrast this with the cost of the increase in Pillar 1 pensions which would arise from increasing the pension to 50% of GAIE
  - The additional cost starts at 1.1% of GNP but is projected to increase to almost 4% by the 2050s.
- Thus, increasing the State Pension on the basis of current tax relief 'savings' will exacerbate the problem of its affordability over time
  - By mid-century, net additional cost of this strategy is projected to be 2.4% of GNP, or €3.7 billion in today's terms

Conclusions (4)

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- The current tax system is not as generous or as biased towards high earners as is sometimes suggested
  - Need to allow for impact of tax deferral i.e. allow for the tax that will be paid by pensioners on their Pillar 2 pensions
- Higher contributors will pay higher tax on their pensions in due course
- Looking at the ‘effective rate of relief’ i.e. the rate taking into account the future payment of tax we find that
  - Those earning roughly €40,000 to €45,000 do best
    - Contributions fully relievable at marginal rate but resulting pension not quite high enough to pay any tax in retirement
  - Effective relief rate falls as you move up the income band (assuming same % contribution rate)
  - Effective rate also falls for an individual if contributions are increased

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