



The Economic Outlook

Implications for Economic Analysis of Pensions Funding Policy

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It's Not Over Yet, Folks

- The worst is behind us?
No: economy will continue to contract into 2010. Why?
- The deflationary impact of the December '09 budget (if it does what it should do)
- Manufacturing & tourism hit by continued weak £ and \$
- But smaller decline in GDP and GNP in 2010 than in 2009, and lower than previously forecast. -1% to -3% rather than -2% to -5%



Budget 09?

- Never mind “Watch my lips, no tax hikes”
- Tax take as a proportion of GNP WILL increase
- But (apart from carbon tax) it is highly unlikely that tax RATES will rise
- Enter Taxation Commission!
- It is simply not possible to introduce a coherent property tax for 2010 on such short notice



“Tax Expenditures” to Square the Circle

- Commission emphasis on review of “tax expenditures”
- Easy to implement
- Tax treatment of pensions signalled as a likely target
- The omens are not good, and spell trouble for the industry



Green Paper and Taxation Commission Report

- Documents laid down principles for change in tax treatment of pensions
- Should not be accepted uncritically, if at all
- No evidence in either document of results of economics analysis of pensions policy
- Three serious analytical errors



Green Paper and Taxation Commission Report

- 1: In present circumstances a concern over fiscal cost is based on a wild overestimate
- 2: The use of an income tax approach to analysing pension savings taxation rather than an expenditure tax approach
- 3: Misunderstanding and misrepresenting the equity implications of the present regime, and the consequences of changing it



The Relief Cost Error

- Both documents perpetuate the myth that the sums involved in income tax relief on contributions are a “cost” to the Exchequer and as such are to be treated as “tax expenditures”
- This is because they do not fully accept the concepts of consumption smoothing and deferred rather than avoided taxation
- The result is the estimate of a net fiscal cost of €2.9 b in 2006



The Relief Cost Error

- The only acceptable measure of fiscal cost is the reduction in the present value of tax receipts over the relevant time horizon
- That means looking at tax at three stages
- Stage I: Contributions
- Stage II: Treatment of pension funds
- Stage III: Pension disbursements



The Relief Cost Error

- Axiomatically this means defining the fiscal cost as follows:
- $$FC = [t_I(\Sigma pv C_I) + t_{II}(\Sigma pv C_{II})] - t_{III}(\Sigma pv P)$$
- Where t_i is the relevant composite tax rate, C is the exempt amount and P is pension disbursement in retirement
- The Green Paper and Commission measure FC as
- $$FC = t_I C_{I 2006} + t_{II} C_{II 2006}$$



The Relief Cost Error

- This is an annual cash flow magnitude, and will overestimate real cost on the same basis as deducting investment expenditure from current revenue will give a poor estimate of profit
- Despite the availability of Revenue and Department of Finance data, no effort was made to use a more robust measure of cost



The Expenditure Tax Approach

- There is no proper expenditure tax operational across the board in Europe
- Instead of taxing income at (say) 25% on tax consumption at 33%
- The concept is equitable
- Income tax double taxes saving; Exp tax is neutral between present and future consumption, therefore pension friendly



The Expenditure Tax Approach

- In most EU15 countries the IT code actually ring-fences income used for pension purposes to be taxed on an expenditure tax basis. This is supported by the EU Commission



Current Tax Treatment in Ireland is Expenditure Tax Based

- Jargon: E = exempt, T = taxed
- 3 “stages”: contribution, in-fund, draw-down
- When pensions are taxed on an E-E-T or T-E-E basis, the gross income involved is taxed on an **expenditure tax**, not an **income tax**, basis.
- If taxed E-T-T or T-T-E or T-T-T or T-E-T they are taxed on an income tax basis



Green Paper, Commission

- GP and Commission use same methodology: income tax basis and costs based on “tax expenditures”
- Recommended reduced exemption for higher taxpayers (30% in short term) and longer term shift to direct subvention rather than Stage I exemption
- €1 for €1.60 state contribution = 30% exemption to 41% taxpayers with subvention to those on lower tax rates



Green Paper, Commission

- Commission proposals effectively impose a tax of (at least) 11% at Stage I on contributions from 41% income tax payers, while taxing the distribution at the marginal rate
- It involves therefore moving from E-E-T to T*-E-T, abandoning the expenditure tax treatment in favour of a moderated income tax treatment



Cost and Subvention

- Incoherent:
- Zero rate, -.30% 0% 0%; >E-E-E
- 20%, -10% 0% (0% or 20%) >E-E-E/T
- 41%, 11% 0% (20% or 41%) T-E-T
- Relative to present position this means a positive incentive to save via pensions up to 41% and a disincentive thereafter
- To avoid this distribution tax for 41% tax contributors should be 9% or 30%



Equity Issues

- The fiscal cost of tax treatment is treated as a transfer to the pension contributor
- Since the cost is over-estimated, the sum transferred is over-estimated.
- Worse, the true distribution of the sum between recipients is not the gross tax relief at stages I and II
- Culligan (IAPF 2008) has demonstrated this defines this as $[t(\Sigma PVC) - (\Sigma PVTr)] / \Sigma PVC$ (my notation) where t is the tax rate, C is the exempt amount and Tr is tax in retirement



Equity Issues

- Simplified two stage model: Culligan's definition of the effective as opposed to headline relief:
- $[t_c(\Sigma pvC) - t_r(\Sigma pvP)] / \Sigma pvC$
- (my notation) where t_c is the tax rate at stage I, C is the exempt amount, t_r is tax rate in retirement and P is the pension disbursement



Cost and Subvention

- This can be manipulated to give
- **$ERR = t_c - t_r [(1 - t_c) / (1 - t_r)]$**
- If $t_r = 0$ the headline relief is the effective relief
- In general ERR will be lower than the headline rate
- Culligan demonstrates that after €50,000 the ERR falls as income rises for “standard employees”



Estimates of Effective Rates (Culligan, 2008)

Salary	Headline Rate	Effective Rate
€25,000	22%	22%
€35,000	22%	22%
€45,000	43%	43%
€75,000	41.7%	37.2%
€125,000	41.7%	32.3%
€200,000	41.7%	25.2%