An Analysis of the Taxation Supports for Private Pension Provision in Ireland

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Introduction

▶ State encourages private pension savings by the provision of tax relief to incentive pensions saving

▶ Incentives for pensions savings represents the single biggest component of tax expenditures

▶ Incentives very generous relative to other OECD countries

▶ Issues explored:

   ▶ net effective level of tax relief

   ▶ the distribution of net effective tax relief by income level, gender, etc

Overview

Background -
Understanding research done and policy recommendations to date

- Significant difference of findings, OECD reporting results different from Ireland's pension industry.

- OECD has persistently recommended reform of the tax expenditures on private pension provision in Ireland since 1994 on the basis that it is
  - too generous
  - not effective
  - iniquitous
  - unsustainable.

- Such findings echoed by the Commission on Taxation (2009), which proposed that the current tax relief be abolished and replaced by a matching contribution of €1 for each €1.6 contributed.

Background -
Understanding research done and policy recommendations to date

▶ IAPF, Society of Actuaries in Ireland, and other pension representative groups have resisted changes to the current system based on marginal rates.

▶ Commissioned research by the IAPF in Life Strategies (2008), updated by the Society of Actuaries in Ireland (2011), claims that net effective tax relief is lower than the headline rate at all salary levels.

▶ Reduction in pension tax relief incorporated into agreement with Troika, 2010.

▶ After representation from some sections of pensions industry, an alternative proposal, temporary levy on pension funds and changes to SFT adopted instead. Reform of tax incentives deferred.

▶ See Dr Michelle Maher's, *The Politics of Pensions in Ireland*, pp. 208- 233, for a full account of the events and negotiations at that time.

Background –
Understanding research done and policy recommendations to date

- 2014 the influence of the pensions industry weakened

- Largest component of tax expenditures, 45% total tax expenditures 2014, €2.4 billion

- Timely to revisit the total cost, distribution and sustainability of tax incentives, particularly on light of proposed commencement of Automatic Enrolment Supplementary Retirement Savings System

- Analysis of the distribution of net effective tax relief by contributors, broken down by income level, age or gender has not been previously undertaken

  - OECD calculated the effective tax relief granted based on average earnings

  - Our results differ from those in reports from the pensions industry. November 2017, SAI issued Supplementary Note to the 2011 SAI Paper which restated the 2011 figures and what they represented.

Model & Parameters-

Net effective tax relief on Pension Savings

Tax relief is granted on contributions, investment returns and lump sum and pension draw-down is taxed as earned income.

'Exempt-Exempt-partial-Taxed system as opposed to the

'Taxed-Taxed-Exempt' system that applies to other savings.

State gives upfront tax relief over the entire accumulation phase, with some measure of payback with pension drawdown in several decades' time.

To estimate the value of the tax relief for pension savings one must compare the present value of the extra tax reliefs granted to pension savings above ordinary savings.

The 'net effective tax relief' is the effective subsidy granted by the State on each €1 invested in a private pension as compared to other savings.

Model & Parameters-

Net Effective Tax Relief on Pension Savings – Illustrative Example

Pension Saving	€	Ordinary Saving	€
Individual's Post-Tax Contribution	600.0	Individual's Post-Tax Contribution	600.0
Tax Refund	400.0	Tax Refund	0.0
Initial Value of Fund	1000.0	Initial Value of Fund	600.0
Gross Value of Fund End Year 1	1050.0	Gross Value of Fund End Year 1	630.0
Tax Due	0.0	Tax Due (i.e., 30% of €30)	9.0
Net Value of Fund End Year 1	1050.0	Net Value of Fund End Year 1	621.0
Gross Value of Fund End Year 2	1102.5	Gross Value of Fund End Year 2	652.1
Tax Due	0.0	Tax Due	9.3
Net Value of Fund End Year 2	1102.5	Net Value of Fund End Year 2	642.7
…		…	
Gross Value of Fund End Year 20	2653.3	Gross Value of Fund End Year 20	1193.9
Tax Due	0.0	Tax Due	17.3
Net Value of Fund End Year 20	2653.3	Net Value of Fund End Year 20	1176.6
Tax Payable on Drawdown (20% of €2653.3)	530.7	Tax Payable on Drawdown	0.0
Net Value at Drawdown	2122.6	Net Value at Drawdown	1176.6
Present Value of Drawdown	800.0	Present Value of Drawdown	443.4
Net Effective Tax Relief on Original Contribution	35.7%		

Model & Parameters-
Net Effective Tax Relief on Pension Savings

► The effective subsidy to pension savings is found by discounting the expected future tax receipts on pensions when in payment and comparing it with tax revenues foregone on each €1 invested (by way of tax relief on contributions, investment returns and the lump sum payment).

► We built a model to estimate the net effective tax relief.

► Model

- ► estimates the tax, USC, PRSI, deductions on any assumed earned income at any future time.

- ► estimates the tax payable on investment income and capital gain at any future time.

- ► allows for state pension (including perhaps adult dependents additions) and its rate of increase, salary increases, etc.

- ► estimates the growth rate of investment made, in terms of income and capital gains

- ► discounts future cashflows at a suitable rate.

Model & Parameters-

Key Assumptions

- 10% contribution level of salary between employer and employee.

- Employer contributions treated as a BIK to employee.

- Saving period 25 years.

- Period of Retirement 20 years

- Person qualifies for full contributory state pension at retirement, with full dependant's pension if there is an adult dependent.

- State pensions increase in line with general salary escalation.

- Tax on future earned income payable at the same percentage rate as it is at current salary levels.

- Tax on investment income: 0%, 20%, also 30%.

Model & Parameters-

Key Economic Assumptions

Best Estimate:

Basis outlined in Actuarial Standard of Practice PEN-12, Statement of Reasonable Projection – Occupational Pension Schemes and Trust RACs. [Version 1.6, effective from 1st October 2017]

- 1½% inflation,

- 2½% wage growth,

- 4½% investment return after charges

- Max annuity rate at 2% per annum after expenses but before escalation at 1.5%. So annuity rate at an effective 0.5% real.
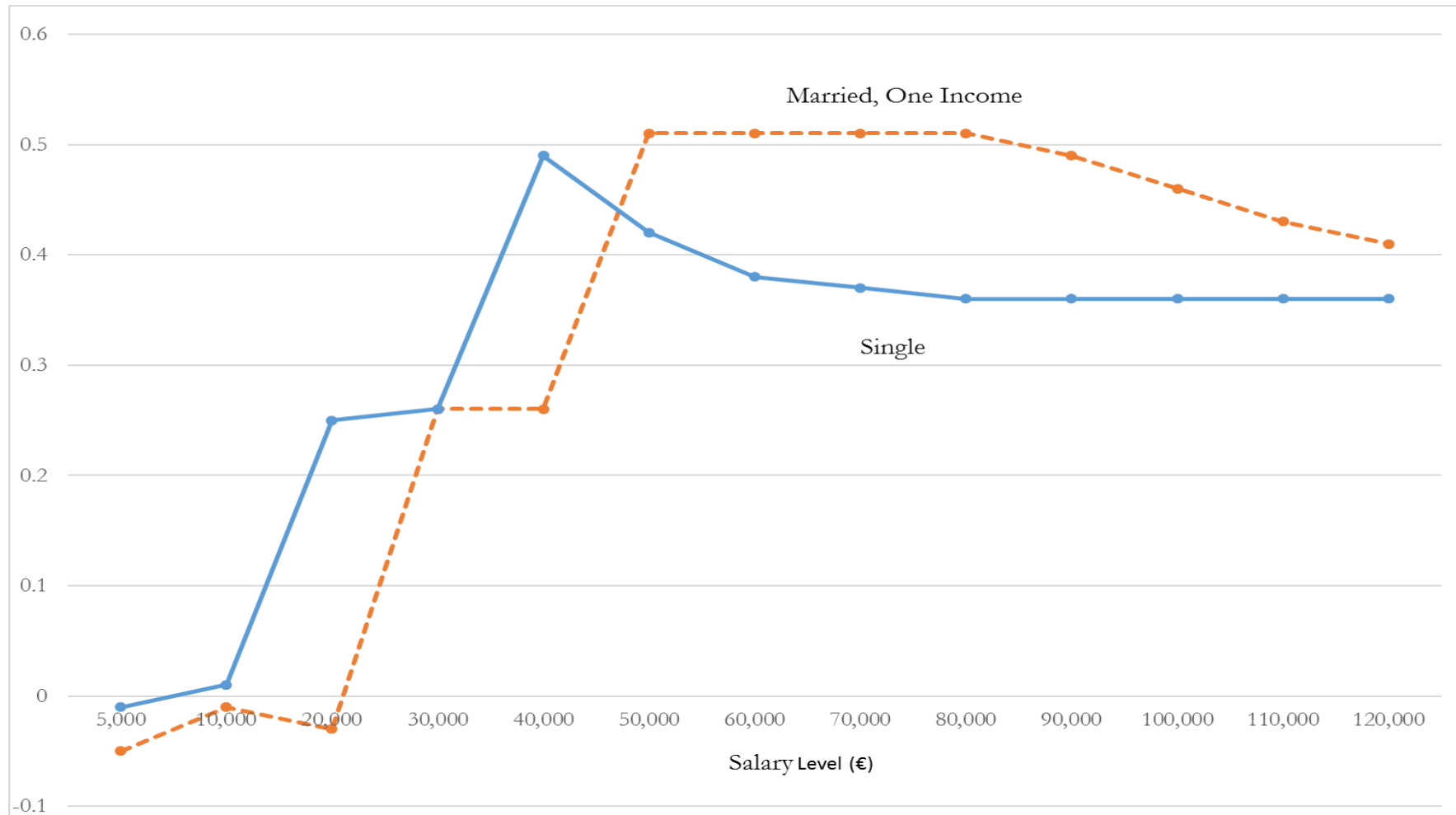
Results -

Net Effective Rate of Tax Relief, estimated assuming individual saves 10% of salary over the 25 years prior to retirement, takes 25% of total fund at retirement as a lump sum and drawdowns the remainder evenly over 20 years

Salary p.a. (€)	Married Person, one income household Tax on Investment Income assumed at			Single Person Tax on Investment Income assumed at		
	0%	20%	30%	0%	20%	30%
5,000	-5%	-	-	-1%	-	-
10,000	-1%	-	-	1%	-	-
20,000	-3%	-	-	-	25%	30%
30,000	-	26%	30%	-	26%	30%
40,000	-	26%	31%	-	44%	49%
50,000	-	46%	51%	-	38%	42%
60,000	-	46%	51%	-	33%	38%
70,000	-	46%	51%	-	32%	37%
80,000	-	46%	51%	-	32%	36%
90,000	-	44%	49%	-	31%	36%
100,000	-	42%	46%	-	31%	36%
110,000	-	39%	43%	-	31%	36%
120,000	-	36%	41%	-	31%	36%

Note: Figures in **bold** represent best estimates.

Results -
Best Estimate of Net Effective Rate of Tax Relief on Pension Savings per €1 Contribution

Results –

Expressing the Net Effective Rate of Tax Relief as an explicit State Subsidy per €1 invested

Salary p.a. (€)	Married Person, one income household		Single Person	
	Best Estimate of Net Effective Rate	Equivalent Government Subsidy per €1 invested	Best Estimate of Net Effective Rate	Equivalent Government Subsidy per €1 invested
5,000	-5%	-€ 0.05	-1%	-€ 0.01
10,000	-1%	-€ 0.01	1%	€ 0.01
20,000	-3%	-€ 0.03	25%	€ 0.33
30,000	26%	€ 0.35	26%	€ 0.35
40,000	26%	€ 0.35	49%	€ 0.96
50,000	51%	€ 1.04	42%	€ 0.72
60,000	51%	€ 1.04	38%	€ 0.61
70,000	51%	€ 1.04	37%	€ 0.59
80,000	51%	€ 1.04	36%	€ 0.56
90,000	49%	€ 0.96	36%	€ 0.56
100,000	46%	€ 0.85	36%	€ 0.56
110,000	43%	€ 0.75	36%	€ 0.56
120,000	41%	€ 0.69	36%	€ 0.56

Results-
Summary

3 distinct income levels that benefit from the tax advantages of pensions savings to different degrees.

Low Income (so do not pay income tax)

- Current system offers no incentive to save for a pension (sometimes disincentivises)
- Net Effective Tax Relief Rate c. 0%

Standard Rate Tax Payers

- EEE system applies up to a retirement fund of 9 times average salary level or 0.33 million for married couple with one income household.
- or to a retirement fund of 4 times average salary level or €150,000 [Single]
- Net Effective Tax Relief Rate c. 25-30%

Higher Rate Tax Payers

- EEE system applies up to a retirement fund of 9 times the average salary or 0.33 million [Married, one income household]
- or to a retirement fund of 4 times average salary level or €150,000 [Single]
- Net Effective Tax Relief Rate c. 31-51%.

Impact of Results on current pension savers

▶ For most pension contributors, net effective rate of incentives greater than previously estimated

▶ Majority contributors, Exempt, Exempt, Exempt

▶ Contributors can target pensions savings to optimise tax relief received

▶ For standard and higher rate tax payers , Positive message !

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Results-
Size/Quantity of Individual Pension Savings

▶ The available data suggests that the average pension pot is below the thresholds identified above. Accordingly, the majority of pension savers will pay no tax on their pension savings at any point in their lifecycle.

  ▶ average PRSA account, 2016, €22,336

  ▶ average fund, active member, DC plan, 2011, €30,586

  ▶ average liability, deferred member, DB plan, 2017, €28,895

  ▶ average liability, active member, DB plan, 2017, €106,825

  ▶ average liability, pensioner, DB plan, 2016, €333,284

  ▶ Average ARF fund, 2015, €107,143

▶ The tax incentives as applied in practice is tax-free saving for pension for most rather than tax deferred saving.

▶ Our analysis agrees with the earlier conclusion of the OECD (2008) that in Ireland "many pensions are unlikely to be fully taxed at any point in the life cycle".

Results-
Size/Quantity of Individual Pension Savings

▶ Collins & Hughes (2017) estimate that in 2014, 70.6% of pension savers are in the higher rate tax bracket, so most pension savers are enjoying tax relief of 31-51%. Indeed, they report that more than half of the total tax relief on contributions in 2014 went to those in the top income decile in Ireland, and more than 80% went to the top three income deciles.

▶ Over 80% of funded pension schemes in Ireland are single member schemes

   ▶ Pension Authority:

      "Ireland has more small and single member schemes than any other country in Europe"

      "just 1% of the EU population, Ireland is home to about 50% of all pension schemes in the EU"

Sensitivity Analysis

▶ The results of the model are dependent on the assumptions used. There are 2 distinct categories of assumptions required in the modelling exercise: assumptions relating to the individual saver and broader economic and investment assumptions.

▶ With the exception of the taxation assumed to be applied to investment returns, the results are not particularly sensitive to the latter. We have run our model on a variety of different economic basis and the magnitude and distribution of the results remains consistent with the final basis used.

▶ The assumptions regarding the individual pension saver relate to contribution level, savings period and drawdown period/longevity. The overall pattern of the net effective tax relief is not fundamentally changed by altering these factors.

Sensitivity Analysis

Investment Return

Figure 1: Sensitivity to Invesment Return
Married, Tax on Investment Income 0%, 20%, 30% dependent on income level

Sensitivity Analysis

Contribution Level

Figure 2: Sensitivity to Contribution Rate
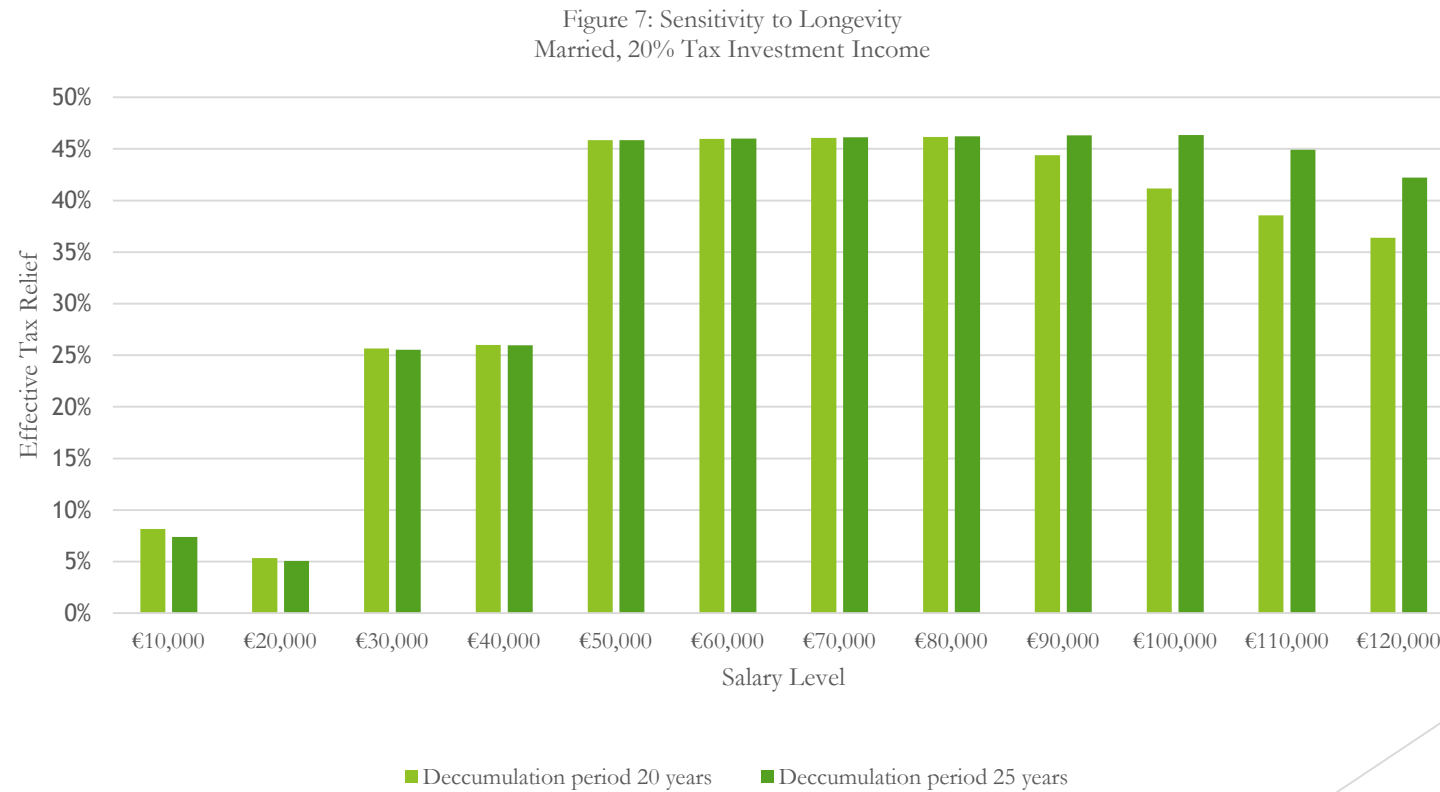Married, 20% Tax on Investment Income

Sensitivity Analysis

Savings Period

Figure 4: Sensitivity to Saving Period
Married, 20% Tax on Investment Income

Sensitivity Analysis

Longevity

Figure 7: Sensitivity to Longevity
Married, 20% Tax Investment Income

Deccumulation period 20 years   Deccumulation period 25 years

1

In 2015, the Government established a 'Universal Retirement Savings Group' to develop a plan for the introduction of a new supplementary workplace retirement saving scheme to help achieve universal supplementary pension coverage, with a particular focus on lower-paid workers.
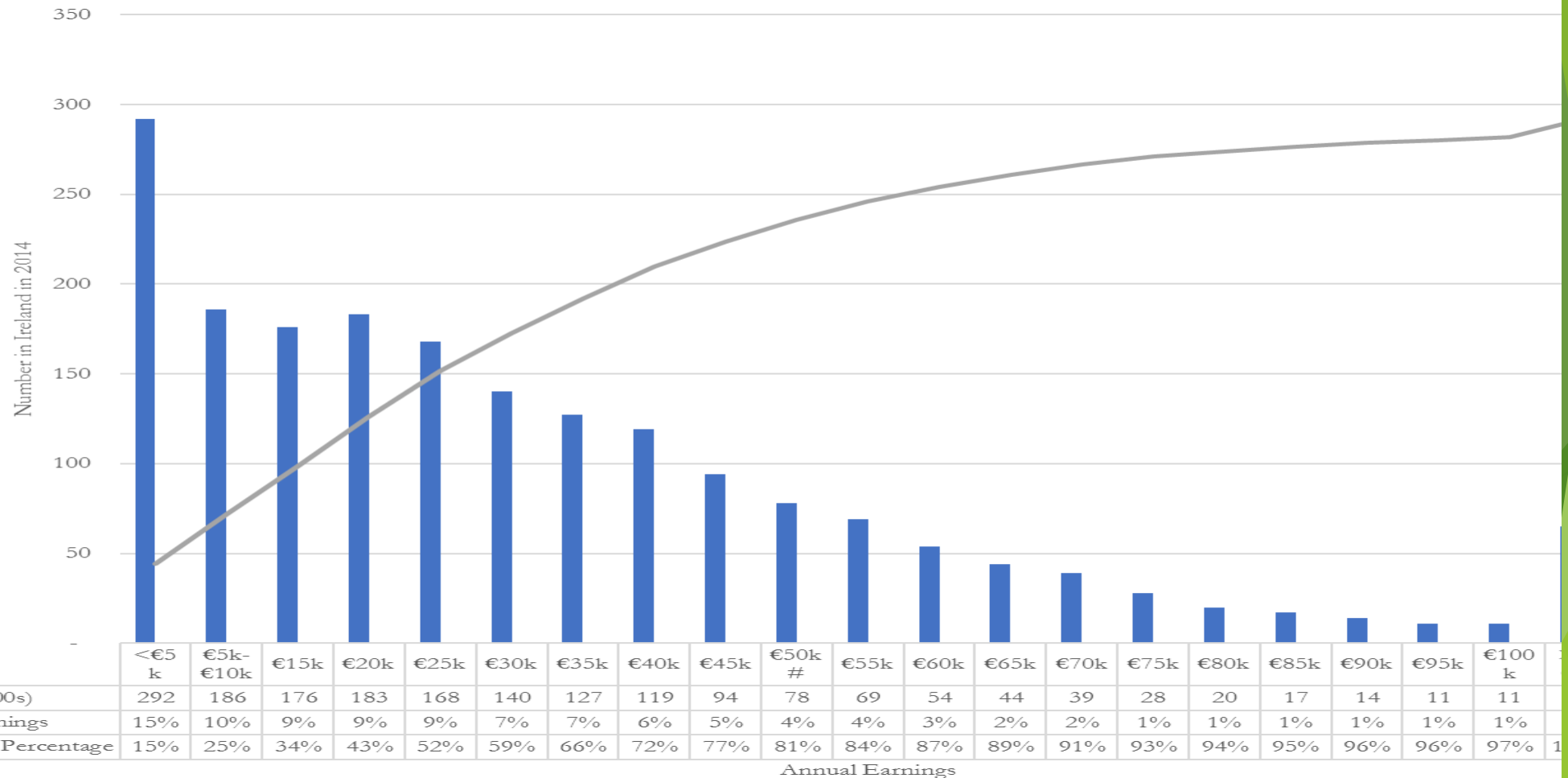
2

A five-year roadmap for pension reform in Ireland was published in February 2018 .The roadmap commits to setting "a formal benchmark of 34% of average earnings for State pension contributory payments by the end of 2018".There is also a plan to introduce an auto-enrolment pension saving scheme for private sector workers.

3

There has been no further information on the proposed scheme however for completeness we have modelled the expected pension of all persons in Ireland with some positive direct income and the best estimate of the net effective tax relief granted on their pension savings under the current tax code, assuming they are married and contribute 5% of their earnings over a 40 year career.

Looking to the future – Automatic Enrolment Supplementary Retirement Savings System

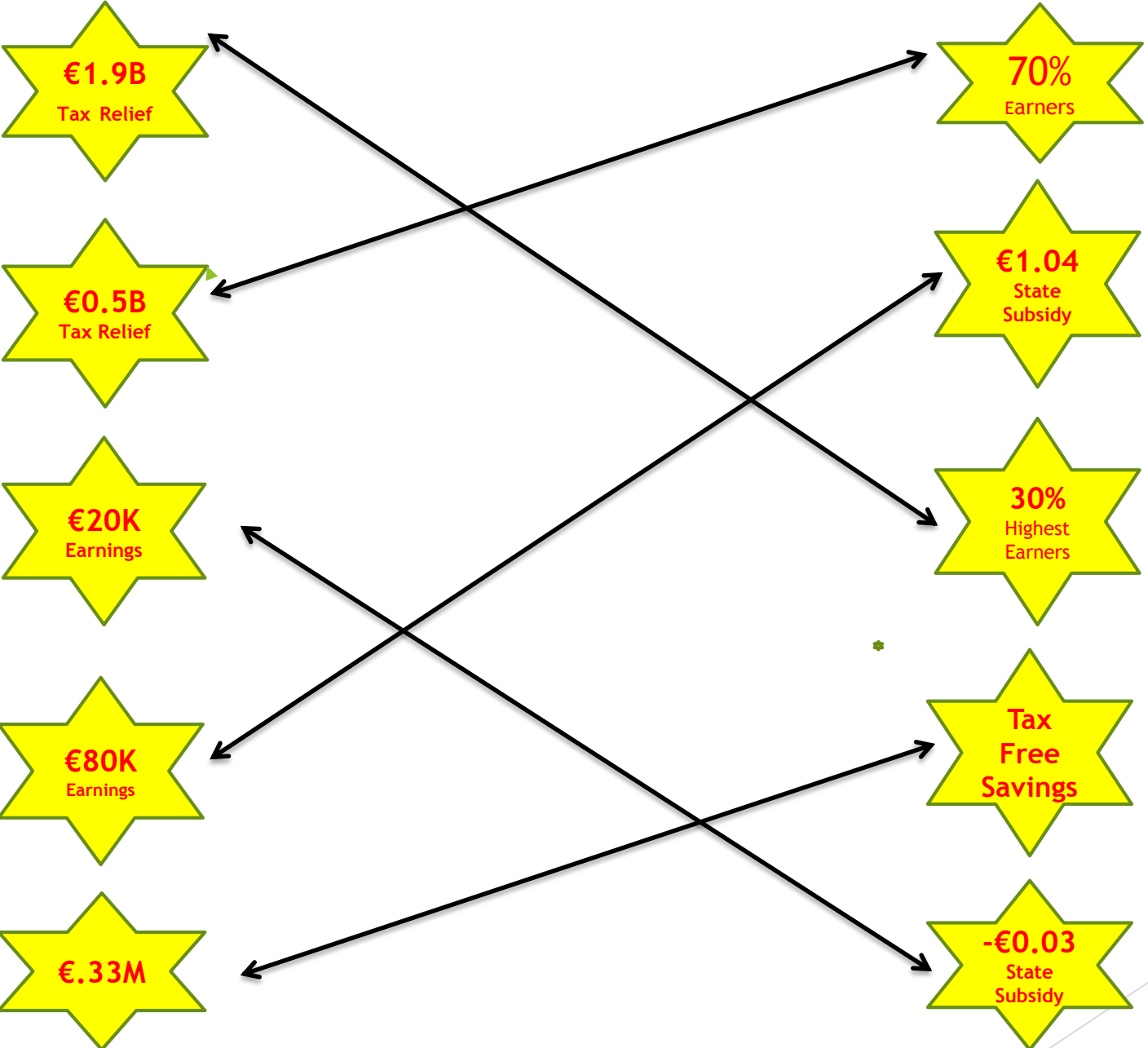# Looking to the future – Automatic Enrolment Supplementary Retirement Savings System

	<€5k	€5k-€10k	€15k	€20k	€25k	€30k	€35k	€40k	€45k	€50k #	€55k	€60k	€65k	€70k	€75k	€80k	€85k	€90k	€95k	€100k
Number (000s)	292	186	176	183	168	140	127	119	94	78	69	54	44	39	28	20	17	14	11	11
% with Earnings	15%	10%	9%	9%	9%	7%	7%	6%	5%	4%	4%	3%	2%	2%	1%	1%	1%	1%	1%	1%
Cumulative Percentage	15%	25%	34%	43%	52%	59%	66%	72%	77%	81%	84%	87%	89%	91%	93%	94%	95%	96%	96%	97%

Annual Earnings

Looking to the future – Automatic Enrolment Supplementary Retirement Savings System

Married , one income family, contribution rate of 5% over a 40-year career, pension drawdown 20 years, taking a tax-free lump sum of one-quarter the fund value. Assumed rate of tax on investment income of 20%.

Income	Direct Income % of All	Cumulative % of Earners	Mean Income	State Pension (monetary value)	State Pension (% of salary)	Top up Pension (monetary value)	Top up Pension (% of salary)	Total Pension (monetary value)	Total Pension (% of salary)	Net Effective Tax Relief
< €10,000	24.7%		€4,161	€23,575	567%	€836	20%	€24,411	587%	12.73%
€10,000-€20,000	18.6%	43.3%	€14,475	€23,575	163%	€2,910	20%	€26,485	183%	10.46%
€20,000-€30,000	15.9%	59.2%	€24,059	€23,575	98%	€4,836	20%	€28,411	118%	11.68%
€30,000-€40,000	12.7%	71.9%	€34,260	€23,575	69%	€6,887	20%	€30,462	89%	31.84%
€40,000-€50,000	8.9%	80.8%	€44,191	€23,575	53%	€8,883	20%	€32,458	73%	44.48%
€50,000-€60,000	6.4%	87.1%	€54,084	€23,575	44%	€10,871	20%	€34,446	64%	51.94%
€60,000-€70,000	4.3%	91.4%	€64,003	€23,575	37%	€12,865	20%	€36,440	57%	50.35%
€70,000-€80,000	2.5%	93.9%	€74,033	€23,575	32%	€14,881	20%	€38,456	52%	43.87%
€80,000-€90,000	1.6%	95.5%	€84,269	€23,575	28%	€16,939	20%	€40,514	48%	38.86%
€90,000-€100,000	1.2%	96.6%	€94,554	€23,575	25%	€19,006	20%	€42,581	45%	34.91%
> €100,000	3.4%	100.0%	€159,740	€23,575	15%	€32,109	20%	€55,684	35%	21.71%

5 Important Questions……………..

The tax relief granted on pension savings is, in the majority of cases, not deferred taxation but no taxation.

The cost to the State & level of incentivising pension savings is far greater than previously estimated.

The cost of the tax expenditure depends primarily on the marginal tax rate of the pension saver and the size of the pension fund at the point of retirement.

The structure of the incentive discourages regular pension savings from those on low pay, or with irregular work patterns.

Conclusion

The current tax-based incentive system for pension savings is regressive.

The value of tax incentives appears to be little understood even by pension experts in Ireland.

System unnecessarily complex, results in many workers not understanding, engaging or benefiting from the tax reliefs available.

Complete decoupling of pension savings incentives from taxation system required to enable equity for all.

Conclusion

"A goal without a plan is just a wish"

~Antoine De Saint Exupery