Presentation to the Pensions Council
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An Analysis of the Taxation Supports on Private Pension Provision in Ireland

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Background

- The Pensions Council identified that an analysis of the tax supports on private pension provision in Ireland is a suitable topic for further research.
- The study will allow the Council to form a view regarding who benefits, to what extent, and how effective the tax regime is at encouraging consumers to save for retirement.
- It would also be cognisant of the costs to the State (in the form of tax relief), the implications of any change in consumer behaviour (such as saving more for retirement) and what approaches are being taken in other jurisdictions.
- This research is aligned with one of the Council's key objectives: to help to ensure that the system has a far stronger consumer focus.

Issues Explored by Whelan & Hally

1. **Understand what research has already been carried out**
2. **Estimate the net effective tax relief on pension savings**

   Estimate the net effective tax relief granted to pension savings, broken down by
   - Income level;
   - Age;
   - Gender;
   - Employment status (employed/self-employed); and
   - Any other factor that may deliver insights to the Council.
3. **Sensitivity of the results to the assumptions made**

   Understand the sensitivity of the results to the assumptions used based on
   - Fair value approach
   - Best estimate approach

     By investment policy pursued
   - Other approaches

Issues Being Explored by the ESRI

- **Understand how the tax relief is distributed**
- Analyse the distribution of net effective tax relief by contributors, broken down by
  - Income level;
  - Age;
  - Gender;
  - Employment status; and
  - Any other factor may deliver insights to the Council.
- **Outline alternative approaches to distributing the <u>current</u> total tax-relief (including other ways to present the tax relief)**
- Propose cost-neutral approaches in which the total tax relief could be
  - Re-distributed more equitably amongst various consumer categories (age, gender, income level, employment status, etc.)
  - Re-distributed to encourage more consumers to save for retirement
  - Presented differently (eg along the SSIA approach and other approaches) to encourage more consumers to save for retirement

Other Parts of Pension Council's Original Proposal

- **Understand the cost to the State under alternative scenarios where the total tax relief increases because of increased consumer retirement savings**
- Analyse the cost to the State in terms of loss of tax revenue in each future year, assuming:
  - Baseline case: Current levels remain unaltered
  - Current trends continue
  - Levels of pension savings meet certain target pension levels

    e.g., 50% of pre-retirement income when combined with State Pension
- **Understand how Ireland compares internationally and what lessons can be learnt from abroad**
- Carry out an analysis to assess the comparative tax incentives given to private pension provision in Ireland with other jurisdictions.

Key Findings

1. Most pensions are unlikely to be fully taxed at any point in the life cycle. This is equivalent to an EEE (exempt-exempt-exempt) model of taxing income that goes towards pensions, at the saving, accrual and payment stages.

2. The system performs badly in terms of equality since marginal tax relief on pension contributions is worth more than twice as much to the minority of high-income households paying the higher-rate of income tax than for those paying the standard rate.

3. The overall level of tax subsidy for pension savings is projected to rise very sharply as the population ages and people build up retirement savings. Indeed, Ireland is projected to have the largest share of income committed to these schemes in 2050 of any OECD country.

Key Findings by OECD

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OECD (2009), p.61

Background (1):
Understanding research done and policy recommendations to date

- Whelan & Hally completed a review of the literature
- Overall there is a difference of finding with OECD reporting results different from Ireland's pension industry.
- In fact, OECD have been consistently calling for reform on how Ireland incentivises pension saving arguing that the current approach:
  - is too generous a subsidy,
  - is not effective in encouraging pension savings generally
  - is not fair, with the higher earners getting higher relief
  - is unsustainable.
- Such findings have largely been echoed by the Commission on Taxation (2009), which recommended that the current tax relief for personal pension provision should be abolished and replaced by a matching contribution of €1 for each €1.6 contributed. The report also recommends that

  "the regime for non-funded pensions should be examined to identify the implicit tax cost to the Exchequer in the context of an equitable distribution of the tax expenditure on pensions" (p. 374).
- It was agreed with the Troika (2010) that tax relief on pensions would be put at the standard rate, not the marginal rate.

Background (2):

Understanding research done and policy recommendations to date

- Minister of Finance in his 2012 Budget Speech

  "Although the EU/IMF Programme commits us to move to standard rate relief on pension contributions, I do not propose to do this or make changes to the existing marginal rate relief at this time. However, the incentive regime for supplementary pension provision will have to be reformed to make the system sustainable and more equitable over the long term."

- The IAPF, Society of Actuaries in Ireland, and other pension representative groups have argued to maintain 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 marginal tax relief does not benefit the higher earners as much as supposed.

(2) Estimate the net effective tax relief on pension savings

- Private pension provision is granted tax relief on contributions, investment returns and the lump sum at retirement or earlier death, and then pension draw-down is taxed as earned income. The tax relief is at the individual's full marginal tax rate. This system is known as the 'Exempt-Exempt-partial-Taxed system as opposed to the 'Taxed-Taxed-Exempt' system that applies to other savings.
- Hence, the 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 and reduce that by the present value of any extra tax that might be payable on pensions.
- The 'net effective tax relief' is the value of the extra tax relief granted to pension savings above ordinary savings. More specifically, 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.

(2) Estimate the net effective tax relief on pension savings

- So 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 and investment returns).
- We need to build a model to estimate the net effective tax relief.
- Model must be able to
  - estimate the tax, USC, PRSI, deductions on any assumed earned income at any future time.
  - estimate the tax payable on investment income and capital gain at any future time.
  - allow for state pension (including perhaps adult dependents additions) and its rate of increase, salary increases, etc.
  - estimate the growth rate of investment made, in terms of income and capital gains
  - discount future cashflows at a suitable rate.

Key Assumptions (1)

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

  [see Table 4, p.34 in Collins & Hughes (2017)].
- Employer contributions treated as a BIK to employee.
- Saving period of 25 years.
- Period of Retirement: We used 20 years and, alternatively 25 years.

  [Note life expectancy at retirement is estimated as 21 years for males and 23 years for females based on 43 year-old in 2017 retiring at age 68 (based on forecast the life expectancy by the CSO latest population and labour force projections.]
- Person qualifies for full contributory state pension at retirement, with full dependants 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: 20%, alternatively 30%.

Key Assumptions (2)

Financial assumptions can be justified on three different approaches or bases.

Fair Value: A value consistent with current market value of the future income streams – the price a willing buyer would pay for the future income stream, with due allowance for the embedded risk, in current market conditions.

Best Estimate: A value based on the best estimate of the components of the cashflows – so best estimate of salary inflation, rate of return on invested funds, etc. This approach does not allow for the market price of risk associated with the cashflows.

Social Time Preference Approach: Society as a whole also prefers to receive goods and services sooner rather than later, and to defer costs to future generations. This is known as 'social time preference'; the social time preference rate (STPR) is the rate at which society values the present compared to the future.

Key Assumptions (3)

Here we present results only on a best estimate basis, as this will be close to the final basis we deem as being the most suitable for this purpose.

Best Estimate: We used the 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,

2 ½% wage growth,

5% investment return prior too retirement before charges, with charges at 0.5% per annum so 4 ½% 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%.

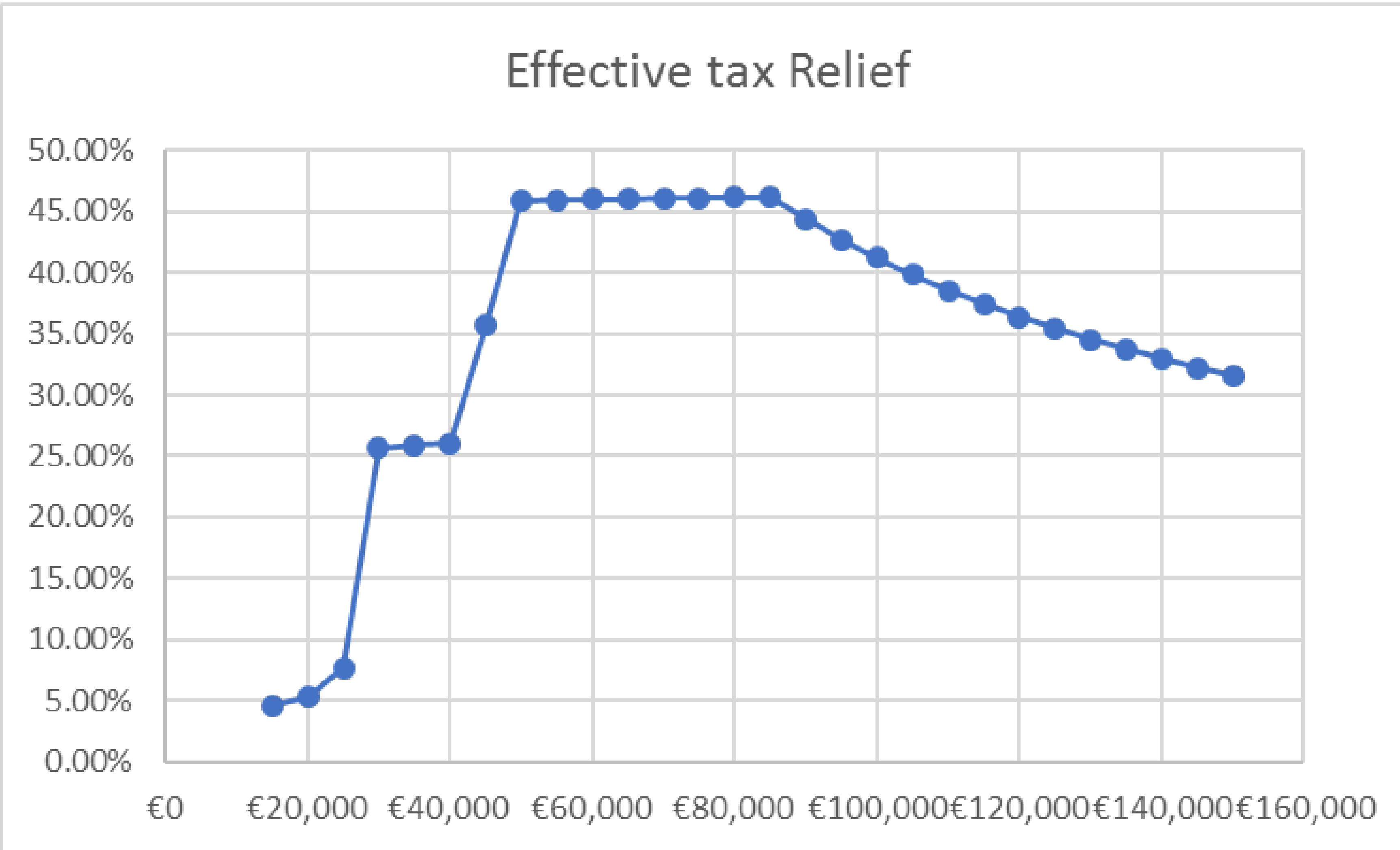
Illustrative Results from our Modelling (1)

Married Person, 1 income, 10% of Salary, Saving Period 25 years, 25% of fund at retirement taken as lump sum, Drawdown evenly over 20 years, 20% Tax on Investment Income or 30% Tax on Investment Income

Salary Level	Best Estimate	
	Tax on Investment Income	
	20%	30%
20,000	5%	10%
30,000	26%	30%
40,000	26%	31%
50,000	46%	51%
60,000	46%	51%
70,000	46%	51%
80,000	46%	51%
90,000	44%	49%
100,000	42%	46%
110,000	39%	43%
120,000	36%	41%

Net Effective Tax Relief by Income Level

Best Estimate Basis, Married one income, contributing 10% of Salary over 25 years, 25% of fund as lump sum, 20% Tax on Investments



Illustrative Results from our Modelling (2)

Single Person, 10% of Salary, Saving Period 25 years, 25% of fund at retirement taken as lump sum, Drawdown evenly over 20 years, Tax on Investment Income at 20% or 30%.

Salary Level	Best Estimate Tax on Investment Income 20%	 30%
20,000	25%	30%
30,000	26%	30%
40,000	44%	49%
50,000	38%	42%
60,000	33%	38%
70,000	32%	37%
80,000	32%	36%
90,000	31%	36%
100,000	31%	36%
110,000	31%	36%
120,000	31%	36%

Sensitivity of Results

Income Level

Lower rates of relief for lower earners – so lower in general for females, for those in lower socio-economic groups.

Longevity (period in retirement)

Results are not particularly sensitive to longevity but, obviously, the longer one lives the higher the fund needed at retirement and so the more contributions get full relief.

Tax Rate on Investment Income

A key sensitivity, increasing with increasing investment return assumed. Used 20% and 30% but 30% is perhaps the more realistic one for higher rate taxpayers.

Discount Rates/Fund Growth Rates

A key sensitivity coupled with the tax rate if fund size breaches the threshold so tax is payable on pension.

Saving Period

Up to certain thresholds, the longer the saving period the higher the net effective tax relief as the more valuable the tax relief on investment income.

Summary of Key Findings for Pension Council

We identify three distinct categories (with a little blurring around the edges).

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 [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. 25%

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. 45%.

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Appendix: Full Quote from OECD (2009), p.61

"Tax relief given against private pension contributions is a very significant tax expenditure. As noted in the 2008 Survey, many pensions are unlikely to be fully taxed at any point in the life cycle. [This is equivalent to an EEE (exempt-exempt-exempt) model of taxing income that goes towards pensions, at the saving, accrual and payment stages (OECD, 2008)]. But the current system of tax incentives does not provide an effective way of achieving adequate private provision, despite the generous level of support. They tend to act to divert funds from other investment, rather than to increase overall pension saving, as they are poorly targeted at marginal savers. The system performs badly in terms of equality since marginal tax relief on pension contributions is worth more than twice as much to the minority of high-income households paying the higher-rate of income tax than for those paying the standard rate. The overall level of tax subsidy for pension savings is projected to rise very sharply as the population ages and people build up retirement savings. Indeed, Ireland is projected to have the largest share of income committed to these schemes in 2050 of any OECD country. Reducing the level should be accompanied by a better targeting of subsidies."

Green Paper on Pensions (2007) estimate of cost of pension relief on a cashflow basis

- In estimating the aggregate cost of tax reliefs on pensions, the Green Paper (2007), using figures published by the Revenue Commissioners, did it on a cashflow basis.
- That is, in each calendar year, they estimate
  - The total cost of tax relief on contributions in the year (including BIK on employer's contributions)
  - Total cost of tax relief on income and gains of pension funds in year
  - Total cost of tax relief on lump sum payments
  - Less estimated tax yield during year on pensions in payment.
- Our modelling approach is better as it relates tax expenditures with expected future tax returns from that expenditure – it does not combined revenue streams from different generations of pension savers (who may differ in number and size of contributions/benefits).