Society of Actuaries in Ireland

Analysis of the Fiscal Incentives for Retirement Savings: Initial Findings

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Analysis of the Fiscal Incentives for Retirement Savings

- Background
- Comparative Methodology
- Ireland – Current Model
- Impact of Potential Changes
- Overseas Comparisons
- Initial Findings

Background

- Study commissioned by the Society of Actuaries in Ireland
- Work funded by the Irish Fiscal Policy Research Centre

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- Reviewed by a joint Steering Group

Study Scope

- Consider the distributional effects of the overall pension system
- Focus on fiscal incentives under funded occupational "second pillar pensions"
- Analyse the relative attractiveness to individuals in different tax brackets
- Consider the effect of certain mooted changes
- Compare Ireland with other well established second pillar pension systems

Initial Findings

- The study required making several long term assumptions
- The overall Irish pension system is progressive
  - Pillar I is both progressive and redistributive
  - Pillar II is progressive with a fiscal incentive for most employees
  - Proposed changes could undermine the existing incentive
- Compared to other countries, the Irish system is more progressive
- In those countries with mandatory participation, there remains a strong fiscal incentive

Rationale for a Fiscal Incentive for Pensions

"While achieving neutrality between different forms of saving and investment is our general aim, there may be a good case for treating pension saving more generously. Behavioural evidence suggests that people tend not always to make decisions in far-sighted and rational ways. Individuals with inadequate retirement savings are also more likely to draw on costly state benefit programmes in retirement. Encouraging them to save in a pension when young makes this less likely."

- The Mirrlees Review; Conclusions and Recommendations for Reform, Institute for Fiscal Studies

Analysis of the Fiscal Incentives for Retirement Savings

- Comparative Methodology

Comparative Methodology

- Fiscal Incentive Index (FII) =

$$\frac{\text{present value of tax relief received on employee and employer contributions}}{\text{present value of tax paid on the pension benefits in retirement}}$$

- A FII > 1.0 indicates a fiscal incentive to save for retirement
- Adequacy and Affordability issues are ignored
- The FII is a Comparative (Relative) measure
- Assumptions matter!

Key Assumptions

- Core study based on individuals commencing occupational pension scheme saving at age 30, 40 or 50, with a contribution rate of 15% of salary (5% from the individual and 10% from their employer)

- Retirement age of 68 with 25% of fund taken as a lump sum and the balance providing a CPI linked income for the next 20 years

Key Assumptions – PRSI related

- All persons subject to Class A PRSI
- State retirement age 68 for all
- State pensions accrue on an N/30ths basis
- PRSI contributions notionally adjusted (reduced) to reflect entitlement to other social welfare benefits

PRSI Payor	Full Rate	Notionally Adjusted Rate
Employee	4%	2%
Employer	10.75%	8.75%

Key Assumptions – Financial Model

- All tax bands and limits assumed to be CPI linked
- Pension Fund Levy ignored

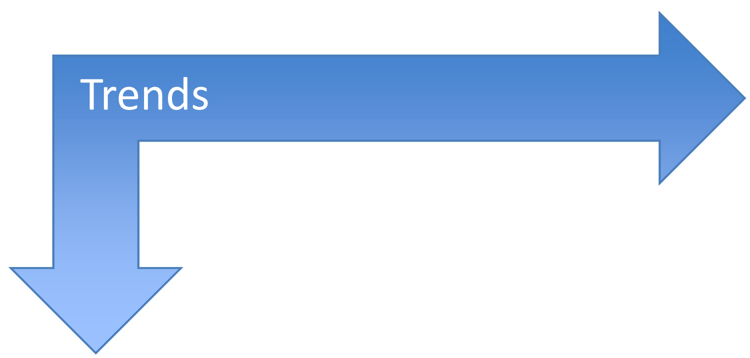
- Salary increase : 1% p.a. above cpi
- Investment return : 3% p.a. above cpi
- Discount rate : 2% p.a. above cpi

Analysis of the Fiscal Incentives for Retirement Savings

- Ireland – Current Model

FII Ratio: Pillars I and II Combined

Salary	Year 1 Pillar II contributions	Year 1 Adjusted PRSI contributions	Fiscal Incentive Index ("FII")		
			Commencement Age 30	Commencement Age 40	Commencement Age 50
30,000	4,500	3,225	**1.0**	1.6	2.9
50,000	7,500	5,375	**0.7**	1.0	1.7
75,000	11,250	8,063	**0.5**	0.7	1.2
150,000	22,500	16,125	**0.3**	0.4	0.7



FII Ratio - Pillar II Only

Salary	Year 1 Pillar II contributions	Fiscal Incentive Index (“FII”)		
		Commencement Age 30	Commencement Age 40	Commencement Age 50
30,000	4,500	2.8	4.9	16.2
50,000	7,500	1.9	3.2	7.0
75,000	11,250	1.2	2.4	4.4
150,000	22,500	0.5	1.0	2.4

FII Ratio - Pillar II Only (but no lump sum taken)

Salary	Year 1 Pillar II contributions	Fiscal Incentive Index (“FII”)		
		Commencement Age 30	Commencement Age 40	Commencement Age 50
30,000	4,500	1.7	2.7	6.2
50,000	7,500	1.0	2.0	3.7
75,000	11,250	0.8	1.2	2.5
150,000	22,500	0.4	0.7	1.2

Analysis of the Fiscal Incentives for Retirement Savings

- Impact of Potential Changes

FII Ratio - Pillar II Only - Reduced Relief

Salary	Current Regime Age 30	Basic rate tax relief or composite rate of 33%	20% tax relief on all individual contributions
30,000	**2.8**	2.5	2.1
50,000	**1.9**	1.7	1.3
75,000	**1.2**	1.0	0.8
150,000	**0.5**	0.5	0.4

FII Ratio - Pillar II Only (SFT Cap Adjustments)

Salary (Age 30)	€2.3m indexed	€2.3m flat	€1.5m indexed	€1.5m flat
30,000	2.8	2.8	2.8	2.8
50,000	1.9	1.9	1.9	1.9
75,000	1.2	1.2	1.2	0.8
150,000	0.8	0.5	0.6	0.4

Analysis of the Fiscal Incentives for Retirement Savings

- Overseas Comparisons

Comparison with Other Countries

Country	Australia	Canada	Netherlands	Singapore	Sweden	United Kingdom	Ireland
Core Pillar II Participation	Mandatory / Voluntary	Voluntary	Mandatory	Mandatory / Voluntary	Mandatory	Voluntary, but auto-enrolment	Voluntary
Lump sum on retirement	Yes (Up to 100%)	No	No	Yes (50% of fund)	No	Yes (25% of fund)	Yes (25% of fund, or service / salary formula)
Corporation tax	28.0%	26.5%	25.0%	17.0%	26.3%	23.0%	12.5%

[1] In Netherlands and Sweden, most pillar II schemes fall under industry-wide arrangements are quasi mandatory in nature.
[2] Australian and Singapore both have a mandatory defined contribution scheme with ability fo additional voluntary contributions.

FII Ratio – Overseas Comparators (Age 30)

Salary € (Age 30)	Australia	Canada	Netherlands	Singapore	Sweden	UK	Ireland
30,000	2.6	1.6	1.9	1.6	0.9	1.5	2.8
50,000	2.7	1.8	1.8	1.8	1.1	1.9	1.9
75,000	2.8	1.9	1.4	1.9	1.2	1.9	1.2
150,000	2.7	1.3	0.9	1.3	0.9	2.0	0.8

Key findings:

- Mandatory systems continue to exhibit a significant fiscal incentive
- Most systems are progressive in nature

NB: Certain simplifying assumptions were made to facilitate calculation of broadly comparable FII ratios across the selected countries

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