Society of Actuaries in Ireland

Press Release
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Report finds fiscal incentives for retirement savings in the Irish pension system are progressive and compare well internationally, but proposed changes could discourage long-term saving

The Society of Actuaries in Ireland, using funding provided by publicpolicy.ie, commissioned Deloitte to analyse the fiscal incentives for retirement savings in Ireland, make comparisons with other countries that have well-established private pension systems and examine the potential impact of certain changes that have been mooted.

The research report is published today at www.actuaries.ie/press/papers and www.publicpolicy.ie.

The report analyses the key components of the Irish pensions system, namely:

- Pillar I - the public mandatory State-run social welfare system, funded on a pay-as-you-go basis by pay-related social insurance (PRSI) contributions and by a subvention from the Exchequer when the cost of the benefits exceeds the contribution income; and

- Pillar II - the private pension system, whereby pensions are provided through a person's employment or through financial institutions acting as pension providers. The State provides direct fiscal incentives, such as tax relief on contributions, to encourage long-term saving. These fiscal incentives are at least partially offset by tax payable on pensions.

For the purposes of the study, the authors developed a "Fiscal Incentive Index" (FII), which is the ratio of tax relief received on employee and employer contributions (plus State pension income, in the case of Pillar I) to tax paid on pension benefits in retirement (plus relevant PRSI contributions, in the case of Pillar I), with all payments expressed in today's money values. Thus:

- A FII value greater than 1 indicates that there is a fiscal incentive for an employee to partake in the arrangement being studied, i.e. the present value of tax relief obtained is greater than the present value of tax paid;

- A FII value less than 1 shows that there is no real fiscal incentive to partake in the arrangement being studied (though there may be other reasons for doing so).

The authors calculated FII values for a range of salaries and ages at commencement of contributions to the pensions system.

Key findings

The following key findings are worth noting:

1. An analysis of the aggregate system (Pillars I and II combined) shows that the relative attractiveness of the system, in terms of fiscal incentives provided, increases as salaries decrease and as age increases – illustrating both the progressive nature of the Irish pension system and the greater incentive to save as an employee gets closer to retirement age.

2. Pillar I is also redistributive, from high earners to low earners and from the working to the non-working population.

3. The progressive and redistributive characteristics of Pillar I derive from the fact that contributions are salary-related whereas benefits are fixed in monetary terms for all beneficiaries.

4. Considering the second Pillar in isolation, we again see a strongly progressive trend - fiscal incentives are greatest at lower salaries, and at higher ages. There is some incentive for all individuals to participate in a Pillar II arrangement. However, for individuals on relatively high salaries, paying contributions throughout the full term to retirement based on the full salary may (depending on the rate of contribution) lead to tax paid on pension benefits being greater than the fiscal incentives achieved.

5. Compared to a range of other countries with well-established second Pillar arrangements[1]:

    5.1. The Irish pensions system is not unduly generous in terms of fiscal incentives and is more progressive than most;

    5.2. In those countries with mandatory participation in Pillar II pension plans, a strong fiscal incentive remains.

6. Reducing the tax relief on employee contributions from the marginal rate of income tax to the standard rate would have a marked impact, making long-term saving less attractive than is currently the case at most salary levels, i.e. for many people. In contrast, the alternative of reducing the cap on pension benefits qualifying for tax relief to €60,000 per annum would affect mainly high income earners.

Comment

A. The research is timely, given the many changes already made to fiscal incentives for retirement savings over the last few years and the choices facing Government as part of the National Recovery Plan.

B. The research confirms that the Irish pensions system is progressive and redistributive, which is desirable from a social policy perspective.

[1] The countries examined were Australia, Canada, Netherlands, Singapore, Sweden and the UK.

C. The research shows that there is a fiscal incentive for participation in a Pillar II arrangement, though not necessarily in respect of full earnings for those on relatively high salaries.

D. Now, more than ever, it is vital to encourage individuals to make provision for retirement. The sustainability of the current State pension system is questionable:

- It is a well known fact that longevity is improving. This is not being matched by increasing fertility rates, with the result that the overall population is expected to age rapidly in future years.

- The "over 65 years old" population in Ireland is projected to increase from 11% of the total population in 2010 to 15% in 2020 and further to 24% in 2060[2].

- The ratio of people of working age to people in retirement is expected to decline sharply – projections suggest a decline from 5.3 workers for every individual over 65 in 2010 to 3.9 workers by 2020 and 2.1 by 2060[3].

E. We concur with the authors of the Mirrlees Review[4]:

"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."

F. However, the research shows that the mooted changes to the fiscal incentives system could have significant impacts in terms of discouraging long-term savings.

- Reducing tax relief on employees' contributions to second Pillar pension arrangements from marginal to standard rate would, for many employees, significantly reduce the incentive to save, possibly to the extent that they would no longer be willing to commit their savings to plans that are not accessible until retirement.

- Reducing the cap on benefits qualifying for tax relief would be preferable. Fewer people would be affected. The change would affect mainly high income earners and a reasonable level of fiscal incentive would be maintained for middle income earners.

G. The research shows that Ireland's pensions system is not out of line with that in other countries, in terms of fiscal incentives, and indeed is more progressive than many. Decisions on changes to fiscal incentives for long-term savings should have regard to the potential consequences in terms of Ireland's attractiveness as a place to work.

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[2] and [3] Actuarial Review of the Social Insurance Fund 31 December 2010, undertaken by KPMG on behalf of the Department of Social Protection

[4] The Mirrlees Review; Conclusions and Recommendations for Reform, Institute for Fiscal Studies 2001 page 5

H. We hope that this up-to-date research will contribute to a holistic approach being taken to policymaking on fiscal incentives for retirement savings in Ireland.

ENDS

Issued (11th October 2012) on behalf of the Society of Actuaries in Ireland by:

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Society of Actuaries in Ireland

The Society of Actuaries in Ireland is the professional body for actuaries practising in Ireland. Actuaries provide advice and relevant solutions for financial, business and societal issues involving uncertain future events. Most of the Society's members work in the financial services industry, and the profession has a statutory role relating to the supervision of pension schemes and insurance companies.

The Society seeks to make an impartial contribution to public debate on social policy and public interest matters where an actuarial perspective can add value.

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