

**SYMPOSIUM ON PENSIONS: IMPLICATIONS FOR PUBLIC POLICY**

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**1. INTRODUCTION**

I would like to thank the Statistical and Social Inquiry Society of Ireland for inviting me to present a paper at this symposium on Pensions. It is certainly a period of great discussion and debate on pensions and is a very exciting time for a civil servant like myself at the policy coalface of this debate in the Department of Social Welfare.

In my presentation tonight I would like to briefly:

- describe the current pensions system in Ireland;
- outline the pensions debate, the range of players here and the current focus of this debate, which is the National Pensions Policy Initiative; and
- explain the background to this Initiative, which is jointly sponsored by the Department of Social Welfare and the Pensions Board, and the progress to date.

I would then like to examine the Social Welfare pensions system. Finally, I will outline some issues for the future as I see them.

**2. CURRENT PENSIONS SYSTEM**

At present pension cover in Ireland is provided under three tiers or pillars:

- Social Welfare, comprising both social insurance and social assistance pension payments (First Tier);
- occupational pension schemes established voluntarily by employers to cover employees in particular firms or organisations and personal pension arrangements established on a voluntary basis by the self-employed and those in non-pensionable employment (Second Tier);
- non-pension private savings or asset accumulation (Third Tier).

These tiers should not be seen in a stand alone way as they are inter-related, with the first tier setting the basic cover and the other tiers building on this. Arrangements

under the second tier are often integrated with the Social Welfare pension. State policy is relevant to all three tiers.

Expenditure under the two tiers is estimated at £2,565 million per annum, comprising:

| Tier                              | £m     |
|-----------------------------------|--------|
| First tier                        | 1,399* |
| Second tier: public               | 569*   |
| Second tier: private occupational | 462#   |
| : private personal                | 135#   |

*Source: NPPI Consultation Document, p.30. \* 1996, # 1994*

Private pension funds have assets of some £19 billion. Overall, it can be seen that expenditure is significant with consequent financial, economic and social effects.

### 3. THE PENSIONS DEBATE

There may be a view that this debate only started in more recent years, and possibly, as a response to some demographic crisis. This is in fact not the case. While there has been growing discussion in the last two years, the debate about pensions coverage and insurability in fact goes back over 20 years. The sequence of events includes the following and I will return to some of these during the paper:

- a green paper on National Income Related Pension Schemes in 1976;
- report of the Commission on Social Welfare in 1986;
- the establishment of the National Pensions Board in 1986, which issued reports over the next 7 years;
- The Pensions Act, 1990 and establishment of the statutory Pensions Board in 1990;
- the Final Report of the National Pensions Board in 1993;
- publication by the Department of Social Welfare of a discussion document on Social Insurance in October 1996;
- the ESRI Report on Occupational Personal Pension Coverage 1995 which was published in October 1996;
- the launch of the National Pensions Policy Initiative in October 1996, and the publication of a Consultation Document in February 1997;
- establishment of the Commission on Public Service Pensions which started work in 1996;
- an actuarial review of the cost of Social Welfare Pensions which is now being undertaken by the Department of Social Welfare; and
- a forthcoming Combat Poverty Agency Report on “The Welfare Implications of Demographic Trends”, which is being undertaken by the ESRI.

There has been much analyses and a wide variety of players in this debate both at national and international level. In Ireland the debate and progress has been very much on a partnership basis.

It is important that the participation in this debate is broadly based and not dominated by a particular sector, interest group or view. In this regard it is good to see that many of the representative groups are holding pension seminars. It is however important that individuals and particularly pensioners comment on what is often perceived as a very technical and complex area but which boils down to a very tangible basic of replacement income in retirement. It is in the interests of good policy formulation that the debate is as inclusive and informed as possible from the start.

#### **4. NATIONAL PENSIONS POLICY INITIATIVE (NPPI)**

One of the recommendations of the National Pensions Board (NPB)<sup>1</sup> was that a survey of occupational pension coverage should be undertaken at regular intervals. Such a survey was jointly commissioned from the ESRI by The Pensions Board and the Department of Social of Welfare and published last year. The report<sup>2</sup> indicated that coverage has not increased over the 1985/95 period, with only 46 per cent of those at work now covered by Occupational/Personal pensions. The report also identified significant segments of the population for which little or no formal provision, apart from the basic Social Welfare payments, exists.

On publication of this report the Minister for Social Welfare launched the NPPI with the overall objective of examining pensions provision and making recommendations on how to address the coverage issue. From the start it was emphasised that this was to be a wide ranging consultation/discussion process across the social partners, the pensions industry and the public in general.

Responsibility for the Initiative rests jointly with The Pensions Board and the Department of Social Welfare. There is a two stage process involving:

- Stage 1 - the publication of a Consultation Document on Pensions (copies of which are available tonight);
- Stage 2 - the gathering of responses to this document by end May 1997, further investigation of specific ways forward leading to a report and recommendations from the Pensions Board to the Minister for Social Welfare by the Autumn of this year.

This Initiative is certainly no small undertaking but rather a very ambitious plan which has been formally endorsed in Partnership - 2000.

Due to time constraints I do not propose to go through this Consultation Document in detail but I would like to say a little about it. Its purpose is to provoke discussion by for example:

- setting out possible aims for a national pensions policy, building on those set out in the Final Report of the National Pensions Board;
- outlining the social and demographic trends likely in the future, together with their impact;
- setting out the main issues to be addressed;
- briefly describing approaches taken in other countries;
- describing a number of possible ways forward;
- posing a number of specific questions on key aspects of provision.

As part of these key questions respondents are asked, for example, to consider and address:

- the adequacy of existing pension arrangements;
- the desirable and realistic occupational coverage levels for different sectors e.g. lower paid employees, the self employed;
- the structure of pensions provision e.g. should it be on an individual or household basis;
- new initiatives that might encourage increased coverage;
- the issue of a possible mandatory element in the Second Tier provision (which at the moment is on a voluntary basis);
- the involvement of the State in regard to pensions.

The Consultation Document aims to inform decisions in these and other areas. Options outlined for discussion include:

- Improving the First Tier - i.e. Social Welfare Pensions;
- Improving the Second Tier by a number of initiatives to grow the present arrangements and increase coverage;
- A State Earnings Related Pension;
- Mandatory Occupational pension cover;
- Industry-wide pension schemes;
- Personal retirement accounts.

This document is set against an international background in which many countries are reviewing and reforming their system of providing State pensions against a demographic situation which is less favourable from a funding perspective than is the case in Ireland.

Measures to reduce costs in other States include:

- reducing the numbers of pension beneficiaries e.g. by raising the pension age, or extending the contribution period;
- lowering benefit levels e.g. by changing the formula on the basis of which the pension amount is calculated, or moving to a less generous indexation mechanism;
- changing the method of financing;
- transferring responsibility for some pension provision to the private sector, e.g. occupational or personal pension systems.

## 5. DEMOGRAPHIC CHANGE

Given the subject matter of this paper, it would indeed be strange if I did not refer to demographic factors. This is dealt with in the Consultation Document along with the real issue of sustainability of existing pension provision and the position is summarised as follows.

*“The sustainability of State pensions depends critically on the rates of payment which are chosen, and their relationship to wages and prices. If there is wage indexation the burden must rise, since the ratio of pensioners to contributors (the employed workforce) is set to rise, particularly from the year 2010 onwards. But if there is price indexation, as has tended to be the case in recent times, the burden will not necessarily rise, assuming even moderate growth in real wages”.*  
(Consultation Document p.35)

On the other hand, the National Pensions Board projections (published in their Final Report, 1993), which were based on an older set of demographic assumptions, are more pessimistic from a pensions standpoint. They assume that the old-age dependency ratio will rise somewhat more quickly than the figures now would suggest. This is part of the reason for the sharp rise in the required tax rate which they forecast. However, the main reason for the rise has to do with their assumption that the rates of payment of Social Insurance and Social Assistance pension would be linked to wages and salaries.

Over the last 20 years pension rates have increased by about 18 per cent in real terms by reference to earnings but have fallen by about 8 per cent in real terms over the last 10 years. The real increase relative to prices over the same periods was around 59 per cent and 10 per cent respectively.

As outlined in the Consultation Document, over a long period, if State pensions were increased in line with the CPI while wages (and hence the tax base) outpaced the CPI by say 2 per cent per annum, this would make a huge difference to the “tax rate” on earned income necessary to support State pensions. Rather than an increase

in the cost of Social Welfare pensions from 13.9 per cent in 1990 to 25.1 per cent in 2035, as estimated by the NPB, this rate would actually fall slightly.

The only statements that can be made with certainty about pension cost projections are that:

- they depend critically on the underlying assumptions which should be made explicit, and
- they will always be wrong!

As already indicated, the Department of Social Welfare, in line with a recommendation of the NPB, is currently undertaking an Actuarial Review of the cost of Social Welfare pensions over the next 60 years, which it hopes to have completed by mid-year to feed into the NPPI process. Again the whole issue of projections and assumptions is central to this exercise. On foot of this it will be possible to look at adjustments in funding that may be required and also to have a way of modelling the longer term implications of proposed changes.

## **6. STATE SOCIAL WELFARE PENSIONS**

The broad role of the State in pensions provision revolves around the financing and administration of Social Welfare and Public Sector pensions, and providing a legislative, fiscal and supervising framework within which private sector pension arrangements can operate.

Within this, I would like to turn to the Social Welfare pension provision in particular and examine some of the issues and trends in policy. These, as I see them, relate to:

- Social Insurability/Coverage;
- Levels of payments;
- Risks of poverty for older people; and
- Funding.

### *Insurability/Coverage*

Social Insurance has been developed to provide contributors with non-means tested benefits when the various contingencies arise. This means that persons covered can look forward to a basic income, for example on reaching retirement age, the level of which will not be reduced by any other sources of income. This means in effect that enterprise and thrift are not penalised, which can be one of the main outcomes of a fully means tested system.

Social Insurance combines features of State income maintenance schemes, based on the principle of solidarity, and of commercial insurance in which benefit entitlements earned are in part related to contributions paid. This is the *contributory*

*principle.* The principle of solidarity means in effect that there is not a proportional link between contributions paid by individual insured persons to finance Social Insurance and the vulnerability of the persons covered.

With few exceptions the following groups are now covered by Social Insurance:

- full-time employees;
- self employed (since April 1988) (for pensions only);
- part-time employees (since April 1991); and
- new Civil/Public Service entrants (since April 1995).

In addition, in 1994 Homemaker Disregards up to a maximum of 20 years were introduced for people working in the home and caring full-time for children (up to age 12) or an incapacitated person. This means that, in the future, periods spent outside the paid workforce working in the home will not debar a person from receipt of a Contributory Old Age pension. As this arrangement was not introduced retrospectively, it will take some period to be effective. Social Insurance in Ireland is therefore now reasonably inclusive by international standards.

Currently, Social Welfare payments to those over age 66 have a direct coverage rate of 82 per cent and taking account of the derived entitlements of adult dependants of pension age, this rises to almost 90 per cent coverage, which is satisfactory and will increase further over time. This is a very positive feature of the current arrangements and provides an excellent bedrock on which to develop pensions.

There is also a change in the composition of old age pension payments with a shift from assistance to insurance payments. For example, the percentage of pensioners in receipt of an old age insurance payment rose from 47 per cent in 1986 to 58 per cent in 1996.

There is of course the (expensive) issue of the individualisation of these payments, and the mechanisms for achieving this which are for another debate. However, it is interesting to note, in passing, that the Old Age non-contributory pension has always been on an individualised basis due to the operation of the means test.

#### *Levels of Payment*

In June of this year the weekly Old Age (Contributory) Pensions rate, for example, will be £78 personal rate, £51 in respect of an adult and £15.20 in respect of a child dependant. These rates can be examined from a number of perspectives including:

- comparison with Commission on Social Welfare (CSW) recommended rates;
- comparison with average net earnings to establish what's happening to replacement rates;

- examination of the relative risk of poverty for those in the older age group; and
- the value for money given by the PRSI contribution rate.

Depending on the criterion adopted a commentator can make statements which are positive or negative, indicating that there are a number of factors at work here. For example, the Contributory Old Age Pension is 112 per cent, and the means tested pension 97 per cent, of the lower end of the CSW recommended rate compared with the lowest level of Social Welfare payment which is 94 per cent of this rate.

However, average replacement ratios for those pensioners dependent solely on these payments are modest and have been falling in most cases over time as indicated in Table 1.

**Table 1 Maximum Rate Old Age Contributory Pension (OACP) and Old Age Non-Contributory Pension (OAP) as a percentage of Average Net Industrial Earnings 1987 - 1995**

| Year | Single OACP | Single OAP | Couple OACP+ ADA | Couple OAP+ADA | 2 OAPS (<80) |
|------|-------------|------------|------------------|----------------|--------------|
| 1987 | 38.2        | 32.7       | 58.3             | 42.9           | 57.1         |
| 1988 | 37.0        | 31.6       | 57.3             | 42.1           | 56.1         |
| 1989 | 36.1        | 30.8       | 56.3             | 41.4           | 55.1         |
| 1990 | 36.1        | 31.1       | 56.5             | 41.9           | 55.8         |
| 1991 | 35.9        | 30.9       | 55.4             | 41.8           | 55.4         |
| 1992 | 35.3        | 30.4       | 55.0             | 44.0           | 55.0         |
| 1993 | 35.0        | 30.0       | 54.2             | 43.3           | 54.2         |
| 1994 | 34.7        | 29.8       | 54.1             | 43.3           | 54.1         |
| 1995 | 34.6        | 29.7       | 54.3             | 43.4           | 54.2         |

In addition, ESRI research indicates that following a considerable improvement in the relative income position of older people in the 1973-1987 period, there was an increase in the number of households headed by persons in receipt of an old age pension with incomes below 50 per cent of the national average over the 1987-1994 period, as set out in Table 2.



**Table 2 Percentage of Households Receiving/Relying\* on Social Welfare Schemes below Relative Income Poverty Lines, 1994 and 1987**

| Poverty line              | Receiving |      |      |      | Relying on |      |      |      |
|---------------------------|-----------|------|------|------|------------|------|------|------|
|                           | 50%       |      | 60%  |      | 50%        |      | 60%  |      |
|                           | 1994      | 1987 | 1994 | 1987 | 1994       | 1987 | 1994 | 1987 |
| Old age (Con) pension     | 2.5       | 0.9  | 33.5 | 11.8 | 1.6        | 1.3  | 45.4 | 15.1 |
| Old age (Non Con) pension | 18.6      | 11.2 | 56.2 | 28.2 | 30.4       | 18.6 | 85.2 | 46.4 |

\* "Relying" refers to a situation where payments from the scheme account for more than 50 per cent of household income.

Source: ESRI (1996) *A Review of the Commission on Social Welfare's Minimum Adequate Income*, p.38, 40.

Table 3 summarises the trend in the risk of relative poverty for households headed by an older person over the 1973-1994 period.

**Table 3 Risks of Relative Poverty for Households Headed by an Elderly Person**

| Relative Poverty Line | 1973 HBS % | 1980 HBS % | 1987 ESRI % | 1994 ESRI % |
|-----------------------|------------|------------|-------------|-------------|
| 40%                   | 12.9       | 7.1        | 3.6         | 3.2         |
| 50%                   | 30.9       | 24.4       | 7.2         | 9.8         |
| 60%                   | 44.0       | 46.6       | 20.9        | 41.5        |

Source: ESRI (1996), *Poverty in the 1990s*, p. 93

The reasons for the shift in the income position of older people relate to the indexing of Social Welfare pension rates broadly to the CPI rather than to earnings increases in more recent years; the deliberate concentration of additional Budgetary resources on raising the lower rates of Social Welfare payments and, finally, the actual position of the pension rate relative to the chosen poverty line in any particular year.

It is clear that pension payments to older people cannot be considered in isolation from other client groups with regard to, firstly, minimum adequacy levels and, secondly, replacement income, and that the question of priorities has to be addressed. We also should not lose sight of the role of the Second tier of the pensions system in this debate, which is what the NPPI is trying to address.

*VFM*

While this is an issue that will be examined in detail in the Department's actuarial review, it is clear that long term benefits represent particularly good value relative to employee contributors at all levels of income, with the exception of single people at high income levels<sup>3</sup>.

### *Funding of Pensions*

As you are aware, Social Insurance funding in Ireland is currently on a Pay As You Go (PAYG) basis. In this context, in my view, any dilution of the PRSI contribution system as a separate and distinct entity reduces the policy options in this area in the longer term, which is when the financing issues may arise.

Studies by bodies like the World Bank and OECD generally tend towards the view that:

- universal PAYG State pensions are unsustainable;
- the State's role should be to target benefits on those unable to provide for themselves; and
- for most people the bulk of their pensions should come from funded schemes.

However, there is considerable debate on this issue and it is far from clear that the PAYG model is inappropriate for funding State pensions. It is simplistic I think to conclude that PAYG is "bad" and Funded is "good".

For example, in a recent paper on Social Insurance, a senior actuary in Ireland concluded that "it just did not make sense to fund Social Welfare pensions and that funding State Benefits would simply create the illusion of security and a financial merry-go-round in the sense of future generations being required to meet interest and capital redemptions for a funded system as opposed to equivalent pensions for a PAYG system"<sup>4</sup>.

In any event, migration to a funded or partly funded system would have to be considered very carefully, not least because the first generation of contributors to any new system would have to pay on the double. They would first contribute on a PAYG basis to the cost of the pensions of the current generation of retired workers, and then, on a funded basis, towards the cost of their own future pensions.

The National Pensions Board examined the method of financing Social Welfare pensions and recommended that Social Insurance contribution rates should be set using the principle of equalised rates of contribution. This approach would involve periodically carrying out an actuarial review of the cost of future liabilities and fixing the rates of contribution at levels designed to meet those costs, with any excess contributions being deposited in a separate account with the Exchequer. A separate pension fund account would be established within the Social Insurance Fund with the arrangements set out in Social Welfare legislation. Contributions at the equalised rates in respect of pensions would then be paid into this account, out of which pensions would be paid.

The Board recommended that equalised rates should be calculated over a 10 year period and that the calculation should be carried out at 5 yearly intervals. In this way the expected future increase in contribution rates could be phased-in gradually over time and there would be reasonable advance warning of future cost increases.

The Department of Social Welfare has formally entered the funding debate with publication of its discussion document on Social Insurance<sup>5</sup> last year and with the initiation of the actuarial review which, as I see it, is far more than just a technical exercise. The NPB recommendations regarding equalised rates and indeed the specific role of the Exchequer contribution to the Social Insurance Fund (which has fallen from 30 per cent in 1986 to 5 per cent at present) presumably falls to be considered following this review.

A point to bear in mind in this funding debate is that, at the personal level, current Social Welfare pensions are guaranteed under legislation which can only be altered by agreement of the Oireachtas - some argue strongly that this gives a greater degree of personal certainty than any actuarially funded mechanism in itself can.

To conclude then, I would summarise the issues and challenges as I see them to be:

- the future role of Social Welfare pensions in the overall pensions system;
- the standalone and the consequent role of this for occupational pensions;
- the other contingencies that the system might cover;
- the individualisation of pension payments;
- the overall financing implications of proposals for the Exchequer, employees, employers and the self employed; and
- the willingness and ability to get agreement among all players on the best way forward to guarantee that adequate and effective pension arrangements are in place for all citizens.

In the final analysis, the eventual shape of any new arrangements put in place will be determined by what is socially and economically desirable and financially feasible, as discussed in the NPPI Consultation Document.

#### **Footnotes**

1. National Pensions Board Final Report, (1993), p. 174
2. ESRI (1996), Occupational and Personal Pension Coverage 1995
3. Kehoe, JR (1996), Social Security in Ireland, An Actuary's View, p. 5
4. Kehoe, JR (1996) p. 10
5. Department of Social Welfare (1996), Social Insurance in Ireland.