

SYMPOSIUM ON PENSIONS: IMPLICATIONS FOR PUBLIC POLICY

GERARD HUGHES*

Economic and Social Research Institute

(read before the Society, 13 March 1997)

1. INTRODUCTION

The Department of Social Welfare and the Pensions Board commissioned the ESRI to undertake a national survey of pension coverage in 1995. The survey shows that only half of all employees at work are covered by an occupational pension scheme (see Hughes and Whelan (1996)). Despite the considerable efforts of the pensions industry to promote occupational pensions the survey indicates that pension coverage is not increasing. However, the quality of occupational pension provision has undoubtedly improved over the years as the amount of income replaced by occupational pension benefits has risen.

At the publication of the ESRI report last Autumn the Minister for Social Welfare launched a National Pensions Policy Initiative to promote debate on pensions issues and on how best to increase coverage of income-related pensions. Stage I of this initiative has now been completed with the issuing last month by the Department and the Board of a Consultation Document (Department of Social Welfare, 1997)

2. CONSULTATION DOCUMENT

The publication of the Consultation Document is very welcome. It rekindles debate on national pensions policy by specifying the objectives of the Initiative, outlining the current position, dealing with qualitative and quantitative aspects of pensions delivery and with the evolving pensions environment, looking at other countries whose experience is regarded as of interest to Ireland, and considering six principal options for the way ahead. These options are:

1. Increase coverage of occupational schemes on a voluntary basis.
2. Improve the first pillar State pension scheme.
3. Introduce a second pillar State Earnings Related Pension Scheme (SERPS).

* I am grateful to Brian Nolan for supplying data on the distribution of pension scheme members and for comments on an earlier draft and to John Fitz Gerald for comments on an earlier draft. Neither of them are responsible for the views expressed in this paper.

4. Make occupational pension cover mandatory.
5. Promote voluntary industry-wide occupational schemes.
6. Introduce personal retirement accounts.

A crucial question in relation to these options is what role will the State play? Will it be directly involved in providing income-related pensions through a new State scheme or a mandatory occupational scheme or will it be confined to regulating the private pensions market?

The Consultation Document notes that the National Pensions Board considered the option of a State income-related pension scheme in its final report. It points out that:

The Board ... had serious reservations as to whether a second tier income related pension scheme under social insurance would be sustainable in the longer term, in light of the demographic projections and the projected level of contributions required just to finance first tier social insurance pensions. (Department of Social Welfare, p. 59)

The Consultation Document shares these reservations and observes that “SERPS is also very vulnerable to demographic changes when financed on a pay-as-you-go basis.” (Department of Social Welfare, 1997, p. 46)

In addition, the Consultation Document argues that such a scheme is “by definition of less benefit to those outside the labour force, or with low lifetime earnings.” (Department of Social Welfare, p. 46) It does not mention that occupational schemes, by definition also, do not benefit those outside the labour force. Neither does it acknowledge that persons with low lifetime earnings are far more likely to benefit from a State income-related scheme than they are from voluntary occupational schemes.

The Consultation Document raises some issues about State schemes which have become fashionable since the publication of the World Bank (1994) report on *Averting the Old Age Crisis* some years ago. The Document argues that there “... is a risk that a pay-as-you-go SERPS scheme could result in the discontinuance of existing occupational schemes, with a fall in the national savings rate as the funded sector contracts.” It also argues that occupational schemes “...would be pre-funded, and thus would raise the savings rate.” (Department of Social Welfare, pp. 46-47) The Document does not provide any costings of the various options considered. It considers the financial effect of the various options and concludes that the SERPS option is the only one for which there are long term doubts about sustainability

The Consultation Document notes that the favourable tax treatment of pension funds has been a powerful incentive encouraging the growth of occupational pension provision. It notes that the National Pensions Board considered the tax treatment of

occupational pension schemes, that the Board did not recommend any changes, and that its position is that:

...the present treatment of pension funds is simple to understand and operate, is broadly equitable and clearly acts as a major encouragement to the establishment of funded occupational pension schemes. (Department of Social Welfare, p. 15)

If these arguments are valid they weaken the case for a State income-related pension scheme. In my contribution to this symposium I want to consider four key points which can be summarised as follows:

1. A State scheme is unaffordable in the light of demographic projections.
2. A State scheme could result in the discontinuance of occupational schemes.
3. Funding pensions would raise the savings rate.
4. The tax treatment of occupational pension funds is broadly equitable

3. DEMOGRAPHIC PROJECTIONS

The demographic projections on which the National Pensions Board based its reservations about the cost of State pensions were criticised by Hughes (1996) for being too pessimistic. Subsequent demographic projections by McCarthy (1995) and Walsh (1996) showed that the situation was far from alarming. In a forthcoming report for Combat Poverty, on the *Welfare Implications of Demographic Trends*, Fahey and FitzGerald (1997) provide a detailed critique of the Board's demographic projections and comparisons with more recent projections made by the CSO, and by the ESRI for Forfás. They point out that the Board's projection shows total population falling from 1991 onwards as a consequence of very high emigration between 1991-2006. They argue that: "Recent developments have proven ... [the Board's] assumptions to be quite wrong in the short term." (Fahey and FitzGerald, 1997, p. 6.8). Their central conclusion is that

"...the additional burden on public spending which will arise from the growth in the elderly population should be quite manageable and gives no cause for alarm about the sustainability of social welfare pensions, health services or other social services for older people for the foreseeable future." (Fahey and FitzGerald, 1997, p. 6.16)

4. THE RISK TO OCCUPATIONAL SCHEMES

The Consultation Document argues that the introduction of a State income-related scheme could lead to the discontinuance of occupational schemes. It notes in Section 8 of the Appendices and Tables that occupational pension coverage in thirteen countries falls into three distinct bands. The first band contains Switzerland, France, the Netherlands and Denmark and has mandatory or collectively bargained occupational schemes which provide coverage rates ranging from 80-100 per cent. The second band contains the UK, Germany, Ireland, Belgium, and Luxembourg and has voluntary occupational schemes which provide coverage rates ranging from 30-50 per cent. The third band contains Portugal, Spain, Italy, and Greece and has voluntary occupational schemes, mainly for executives, which provide coverage rates ranging from 5-15 per cent.

If the reason for these differences in coverage is the existence of State income-related pension schemes one might expect, as Gordon (1988, p. 163) points out, that there would be “an inverse relationship between employers’ contributions to social security and their contributions to private pension plans”. A test of this hypothesis “did not reveal a consistent relationship between contributions to social security and to private pensions.” Clearly, occupational schemes can coexist with a State income-related pension scheme. They do so successfully in nearly all of the countries in the first and second bands mentioned above.

5. PENSIONS FINANCING AND SAVINGS

In an ideal world characterised by perfect capital and labour markets, no taxes, and no uncertainty the life-cycle model of savings predicts that pension saving is a perfect substitute for other kinds of saving (see Munnell, 1982). However, the world we live in is characterised by imperfect markets, heavy taxation, uncertainty, and many different reasons for saving.

Because of these market imperfections and uncertainty about the future complete substitution of pension saving for other forms of saving may not occur. It is not possible to determine on theoretical grounds whether the growth in private pension plans has resulted in a net increase in national saving or merely a change in the form of saving.

If the argument that funding pensions leads to an increase in national saving is valid it is reasonable to expect that countries which have funded occupational pension schemes would have higher national savings rates than countries which do not. Table 1 and Figure 1 present data from the World Bank and the OECD on pension assets as a percentage of GNP in 1990-91 and on average gross saving as a percentage of GDP in the period 1990-92.

Table 1 Occupational pension assets as a percentage of GNP (1990-91) and average gross national saving as a percentage of GDP (1990-92)

Country	National Savings/GDP	Pension assets/GDP
Australia	17.9	39
Austria	25.8	-
Belgium	21.3	-
Canada	15.4	35
Denmark	18.6	60
Finland	17.3	-
France	20.7	3
Germany	22.5	4
Greece	14.9	-
Iceland	15.4	-
Ireland	19.6	37
Italy	18.7	-
Japan	34.3	8
Netherlands	24.9	76
New Zealand	18.1	-
Norway	23.5	-
Portugal	25.9	-
Spain	20.9	-
Sweden	16.5	-
Switzerland	30.2	70
Turkey	19.8	-
United Kingdom	13.8	73
United States	15.1	66

Sources: World Bank (1994, Table 5.1); OECD (1994, Table 2.1); Irish Association of Pension Funds Investment Survey 1990 and 1991.

Note: The figure for gross national savings for Ireland is overstated in the OECD report.

This table shows that there are only eight OECD countries which have well developed privately funded occupational pension systems, i.e., countries in which pension assets amount to over 30 per cent of GNP. The remaining fourteen countries either have no privately funded occupational pension schemes or have schemes which cater for only a small minority of the population. Thus, France, Germany, and Japan have some privately funded occupational schemes but the value of pension assets in these countries is less than 10 per cent of GNP.

Average gross saving as a percentage of GDP in countries with well developed funded schemes was 19.4 per cent whereas in countries without such schemes the average gross savings rate was 20.1 per cent. There appears to be little difference in the level of national saving between countries which have funded schemes and countries which have not.

It may be argued that it is the scale of pension saving which matters and that countries which have mandatory occupational schemes and which do a lot of their saving by accumulating pension assets will have higher national saving rates than countries which do not. This hypothesis is explored by regressing the gross national savings rate on the pension savings rate in countries which have well developed occupational pension schemes:

$$S/GDP = 13.28 + 0.11 PA/GNP, R^2 = 0.1128$$

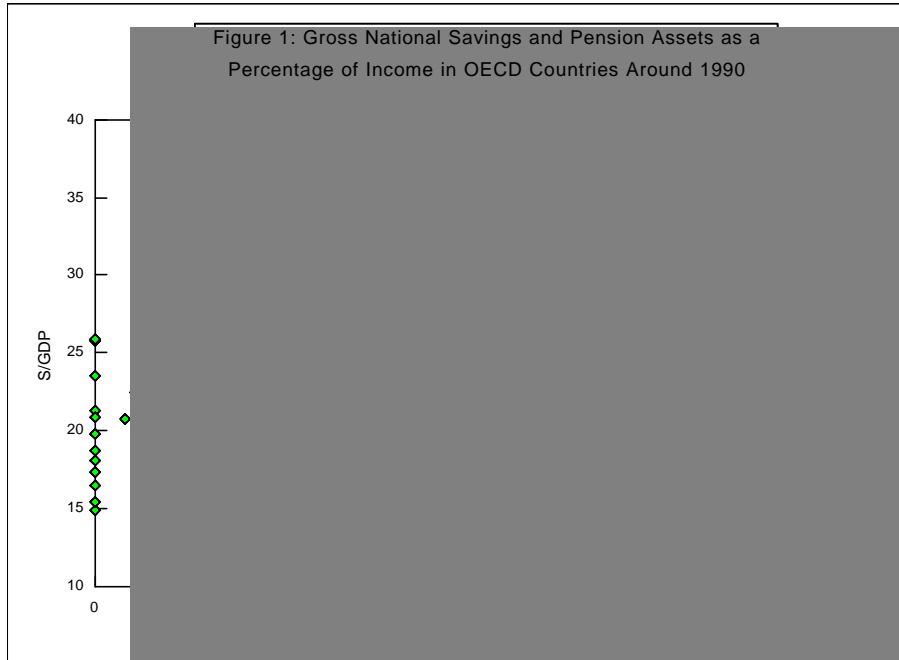
(1.81) (0.87)

where S = gross national saving, GDP = Gross Domestic Product, PA = Pension assets, and GNP = Gross National Product.

The t-value on the pension asset variable shows that the coefficient of this variable is not significantly different from zero. Hence, countries which accumulate large amounts of their assets in pension funds do not appear to have any higher national saving rates than countries which do not.

There could, of course, be a positive relationship between pension financing and national saving which might be captured in a more complex model designed to take account of different influences on savings behaviour and of different methods of financing pensions. Economists have used the life cycle savings model to try and establish empirically the nature of the relationship between pension saving and national saving. Their efforts to answer this question have generated continuing controversy since the early 1970s when Feldstein (1974) first used econometric methods to investigate the relationship.

Since then studies of the relationship between different methods of financing pensions and savings have been carried out in Canada, France, Germany, Italy, Japan, Sweden, the United Kingdom, and the United States. There is not time to review the large international literature on the relationship between pension financing and national saving. However, a recent summary of the results of 25 time series and cross-section studies carried out over the last twenty years in these countries shows that economists are split down the middle on whether there is any relationship (see Hughes (1996)). About half of the studies conclude that there is no evidence that pension saving increases national saving while the remainder suggest that it does. In the light of this evidence and the fact that there is no apparent difference in national saving rates between countries which fund occupational pensions and countries which do not, the idea that funding pensions increases national saving is not persuasive.



6. BENEFICIARIES OF PENSIONS TAX EXPENDITURES

With the reduction in recent years of mortgage interest tax relief the cost of allowances and reliefs on pensions is now among the largest provisions for tax relief in the Revenue Commissioners list.¹ The development of occupational pension schemes is encouraged by means of tax reliefs on employer and employee contributions, on the investment income and capital gains of the funds, and on lump sum benefits on retirement. Income tax is payable at normal income tax rates on the pensions paid to retired members. The Consultation Document notes that:

These arrangements are seen as deferring tax liability rather than conferring a tax exempt status, since pensions in payment (aside from lump sums) are fully liable to income tax in the normal way. (Department of Social Welfare, p. 14)

Nevertheless, the exemption of tax on contributions and fund income and the deferment of tax on pensions until they are paid at a time in the life cycle when tax rates are lower than when members are contributing to their fund bestows considerable financial benefits on pension funds.

¹ Structural reliefs are assumed to be part of the benchmark tax system.

The Consultation Document reports in Table I that the Revenue Commissioners estimate that in the calendar year 1993 the tax reliefs on employer and employee contributions cost £200 million while the cost of reliefs on the investment income of the funds amounted to £125 million and the cost of reliefs on lump sum payments at retirement amounted to £20 million. The Commissioners also estimate that tax receipts on pensions in payment was £95 million. Taking account of these different cash flows and assuming that a reduction in the value of the reliefs on pensions would probably result in some change in behaviour, which could effect the income of the funds, the cost of the tax expenditure on occupational pensions lies in the range £200- £250 million. The estimated cost of the Exchequer subsidy to the State Contributory Old Age and Retirement Pension schemes in the same year was £113 million (see Table 2).

Table 2: Cost of Tax Relief on Occupational Schemes and of Exchequer support for the State Contributory Old Age Pension Schemes in 1993

	Occupational Schemes	State Contributory Old Age Pension Schemes
Cost of tax relief on occupational schemes and Exchequer subsidy to State schemes	£200-£250 million	£113 million
Number of members of contributory occupational and State schemes	291,900*	930,000
Average subsidy per contributor	£685-£856	£122
Pension fund assets	£13,937 million	-
Pension fund assets as percentage of GDP	48.8%	-

Sources: Annual Report of the Revenue Commissioners, 1995; NESC (1996); IAPF, Investment Survey 1994; National Income and Expenditure, 1993.

* 1995

Note: The cost of the Exchequer subsidy to the State pension schemes is estimated from employer and employee contributions to the Social Insurance Fund, an average PRSI contribution for old age pensions of 5.71 per cent, and the difference between expenditure on contributory old age pensions and the estimated amount paid into the fund by employers and employees.

In terms of members contributing to occupational and State pension schemes these figures suggest that the Exchequer subsidy was in the range £685 - £856 per contributor for occupational schemes and £122 per contributor for the State schemes. It is likely that the subsidy to occupational schemes will increase significantly in the future. The Consultation Document gives projections in Table H of pension fund cash flows for the period 1996-2036 which show that total cash flow, net of benefit payments and expenses, will increase by 100 per cent in real terms and that pension fund assets will build up from their present level of nearly 50 per cent of GDP to 115 per cent in 2036.

Estimates of the cost of tax expenditures on pensions are not, of course, uncontroversial. An important issue concerns the appropriate time horizon for the estimates. The Revenue Commissioners use a cash-basis to estimate the cost in a given year. Munnell (1982) and other economists argue that it would be better to make the estimates over a long time horizon, using a net present value basis, so that the discounted value of the tax payable on pension benefits can be taken into account on the same basis as other income flows. However, “all [OECD] countries reporting pensions tax expenditures currently do so on a cash-flow basis” as the OECD (1996, p. 12) points out. In addition, the use of the net present value approach in studies for the United States actually gives a higher figure than the cash-basis approach (see Munnell (1982)).

Individual tax payers are obliged to include details on their annual income tax return of VHI payments or mortgage interest payments for which they are claiming tax reliefs. Consequently the Revenue Commissioners have information on the distribution of these tax reliefs by income class. Unfortunately, because of the way in which the reliefs on pension contributions and pension fund income are given we do not know how different income groups benefit from the tax expenditure on pensions.

However, the ESRI 1994 household survey contains information on the gross hourly earnings of employees who are members of any type of pension scheme. Employees are ranked in Table 3 in deciles by level of earnings. The table shows that in the bottom two deciles less than 5 per cent of employees belong to a pension scheme and that nearly 90 per cent of employees in the top two deciles are members of a scheme. In between these extremes the percentage of employees who are members of a pension scheme increases strongly in line with increases in gross hourly earnings. The table clearly suggests that the tax reliefs on occupational pension schemes benefit mainly those employees with above average hourly gross earnings. It calls into question the view of the National Pensions Board that the tax treatment of occupational pension funds is equitable.

The costs and benefits of tax expenditures should be regularly reviewed, in the same way as other Government expenditures, to establish if they are achieving the purpose for which they are intended. Now would be an appropriate time to review the tax expenditures on pensions. We need to know how their long term costs compares with the long term cost of Exchequer support for the State pension scheme and by how much different income groups benefit from the favourable tax treatment of pensions.

Table 3: Employees Ranked by Hourly Gross Earnings Showing the Percentage with Pension Entitlements in 1994 by Deciles

Decile	Percent
First	3.2
Second	6.7
Third	20.3
Fourth	41.4
Fifth	51.6
Sixth	57.7
Seventh	72.4
Eighth	77.8
Ninth	88.9
Tenth	88.7

Source: ESRI Living in Ireland Survey 1994.

The importance of having this information is highlighted by the results of the ESRI survey on poverty in the 1990s (see Callan et al., 1996). It shows that the proportion of households headed by a pensioner which were in poverty increased between 1987 and 1994 using a cut-off of either 50 per cent or 60 per cent of average income. The primary reason for this disimprovement was that the Contributory Old Age Pension was not indexed in line with average earnings (although it did increase more than the rise in prices).

7. CONCLUSIONS

The evidence reviewed here suggests that:

1. There is no cause for alarm about the sustainability of the State pension system.
2. A State income-related pension scheme could coexist with voluntary occupational pension schemes.
3. The idea that funding pensions will increase national savings is not persuasive.
4. The tax treatment of occupational pensions should be reviewed.

For the first time in many years an initiative has been taken to develop national pensions policy. In addition, a Commission on Public Service Pensions is considering the arrangements for pensions in the public sector and an actuarial review is being carried out of the long-term cost of the State old age pension schemes. Within the next year or so crucial parts of the picture relating to our national pension system will fall into place.

Stage 2 of the National Pensions Policy Initiative envisages that the Pensions Board will present a report to the Minister for Social Welfare in the Autumn which will contain recommendations on specific ways forward. In contrast to the very slow progress which has characterised pensions policy in the past we have now moved from dead slow to full steam ahead. While the desire to make up for lost time is understandable, the ageing of our population will be slower and less severe than in other EU countries. We have enough time to evaluate carefully the strengths and weaknesses of the present system and to cost properly the range of policy options which are now on the table.

References

- Callan, T., B. Nolan, B. J. Whelan, C.T. Whelan and J. Williams, 1996.** *Poverty in the 1990s: Evidence from the 1994 Living in Ireland Survey*. Dublin: Oaktree Press, General Research Series No. 146.
- Department of Social Welfare, 1997.** *National Pensions Policy Initiative: Consultation Document*. Dublin: Department of Social Welfare and the Pensions Board.
- Fahey, T. and J. FitzGerald, 1997.** *Welfare Implications of Demographic Trends*, Dublin, Oaktree Press.
- Feldstein, F., 1974.** "Social security, induced retirement and aggregate capital accumulation", *Journal of Political Economy*, 82.
- Gordon, M.S., 1988.** *Social Security Policies in Industrial Countries: A Comparative Analysis*. Cambridge: Cambridge University Press.
- Hughes, G., 1996.** "Would Privatising Pensions Increase Savings?", *Irish Banking Review*, Spring '96.
- Hughes, G., and B. Whelan, 1996.** *Occupational and Personal Pension Coverage 1995*. Dublin: Economic and Social Research Institute.
- McCarthy, T., 1995.** "Ageing Populations and Pension Systems: Time Bomb or False Alarm?" Paper presented to Dublin Economic Workshop, October.
- National Economic and Social Council, 1996.** *Strategy into the 21st Century*. Dublin, Stationery Office (Pn 3115).
- OECD, 1994.** *Taxation and Household Saving*. Paris, Organisation for Economic Co-operation and Development.
- Munnell, A., 1982.** *The Economics of Private Pensions*. Washington, D.C.: The Brookings Institution.
- OECD, 1996.** *Tax Expenditures: Recent Experiences*. Paris: Organisation for Economic Co-operation and Development.
- Walsh, B., 1995.** "The Ageing Population - An Economic Perspective", Paper presented at The Society of Actuaries in Ireland Seminar on Pension and Health Care Issues, November.

World Bank, 1994. *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth.* Oxford: Oxford University Press.