Making Pensions Work for People

TASC Policy Update

JANUARY 2010

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2010 update

Executive Summary

In 2008 TASC, in collaboration with the TCD Pension Policy Research Group, issued a policy brief proposing a new model of pensions that would work for everyone[1]. A lot has happened since then. Financial markets have collapsed, the banking system is in crisis and economies are in turmoil. All of these factors have had a huge impact on pensions. Pension funds have experienced significant loses, with many funds in deficit and unable to meet their commitments to members.

Recent events, coupled with the imminent publication of the Pensions Framework, have prompted TASC and the TCD Pension Policy Research Group to update their recommendations in light of recent events[2]. Public policy is failing to create the conditions needed to ensure that pension provision will provide an adequate income for an aging population. The last two Budgets have effectively eroded recent gains in relation to the State pension by cutting the Christmas bonus while introducing prescription charges and a carbon tax.

We believe that our recommendations are more important than ever given the impact of recent events on pensions. A number of recommendations have been updated and new recommendations have been included relating to regulation and protecting existing occupational pensions that are in deficit.

The TASC pension model is based on two tiers. The first tier involves universalising the social welfare pension to provide a guaranteed income for all older people, thus virtually eliminating pensioner poverty. The second tier is based on the social insurance system and would provide an earnings-related pension, allowing people to save for retirement while removing the risk and uncertainty associated with private pension provision.

[1] The members of the TCD Pension Research Group are: Peter Connell, Information Services, Professor Gerard Hughes, School of Business, Anthony McCashin, Department of Social Studies, and Dr. Jim Stewart, School of Business.

[2] While this update presents the views and recommendations of TASC, the proposals have been developed in collaboration with the TCD Pension Policy Research Group.

The updated TASC Pension Model can be summarised as follows:

- Significantly increasing the Social Welfare pension to 40 per cent of gross average industrial earnings over a five-year period.
- Universalising the (increased) Social Welfare pension, transforming it into a guaranteed income available to all long-term residents of Ireland on reaching the age of 65.
- Establishing a new, Social Insurance (Retirement) Fund. This would be a mandatory Defined Benefit scheme. When taken together with the universal pension, contributors would be guaranteed 50 per cent of their final wage or salary up to a specified maximum.
- Rebalancing pensions from private to public by using reductions in the current tax relief given against private pension contributions to fund reforms, which will benefit all current and future pensioners. This would include:

    - Standard-rating all pension-related tax reliefs at 20 per cent;
    - Reducing to €75,000 the ceiling on earnings which may be taken into account for contribution tax relief purposes.

- Addressing the problems faced by current members of occupational pension schemes by:

    - Introducing comprehensive pension protection systems for both Defined Benefit and Defined Contribution schemes.
    - Amending the Companies Acts to ensure companies continue contributing to Defined Benefit schemes which are in deficit, rather than paying dividends to shareholders.
    - Introducing stronger financial regulation, with the Regulator imposing more stringent requirements on private pension providers in relation to managing risk and fund administration charges.

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As we await publication of the promised Pensions Framework, it is worth assessing the context in which TASC is updating its pension policy proposals. There are a number of recent policy developments in the area of pensions that are considered as part of TASC's update on its pension policy. They include recommendations in the *Report of the Special Group on Public Service Numbers and Expenditure Programmes* (2009) and *Commission on Taxation Report* (2009), the recent ESRI report on *Pensions Policy: New Evidence on Key Issues* (2009), the Renewed Programme for Government (October, 2009) and proposals put forward by the Minister for Finance in relation to Budget 2010. TASC's pension policy update is divided into two parts. Part I considers the implications of recent developments in the area of policy and the wider economy on pensions, and Part II updates TASC's Pension Model and related recommendations to reflect recent developments.

Part I – Pensions Policy in a Changing Context

The pension system in Ireland is based on a combination of public and private provision. The State provides a publicly funded pension through the social welfare system, which costs the Exchequer approximately €4.3bn annually. The pension is intended to provide an adequate basic standard of living in retirement. In many cases, this State pension is supplemented by private pension arrangements, generally through occupational pension schemes and personal pension arrangements. These are regulated by the State and afforded support through the tax system. The cost of tax reliefs to the Exchequer is approximately €3bn[3] annually, and 80 per cent of these reliefs go to the top 20 per cent of earners[4]. The State spends a total of €7.3 bn annually, supporting public and private pensions.

[3] Department of Social and Family Affairs (2009) *2008 Statistical Information on Social Welfare Services.*
[4] Letter dated 11 September 2009 from Secretary General Department of Finance to Clerk of Committee of Public Accounts.

Pensioner poverty

Over the last number of years the State pension has been very effective at reducing pensioner poverty. In 2001 the 'at risk of poverty' rate[5] stood at 44.1 per cent and this fell to 11 per cent in 2008[6], demonstrating the crucial role played by the State pension in alleviating poverty and providing an adequate replacement income to older people. The decision to freeze the State pension, while imposing other overt and covert charges on older people and thus reducing its value, is likely to reverse recent gains in reducing pensioner poverty.

There is a widespread perception that – because pensioners were the only Social Welfare recipients not to have their rates cut in Budget 2010 – our older follow-citizens have escaped the brunt of cutbacks. However, this is not the case. While increases in the State Pension in subsequent Budgets (2006-2009) will have improved pensioner living standards (albeit subject to erosion by inflation up to 2009), the Budgets announced in April and December 2009 have negated some of this progress. The double Christmas payment was cancelled, representing a 1.9 per cent effective reduction in the basic State pension for 2009.

For the first time in several years, the State pension was not increased in December's Budget. The rationale for not increasing the State pension (and for cutting other SW payments) was that the cost of living had fallen. However, much of this drop in the cost of living relates to housing costs, which are of little relevance to older people (the majority of whom own their homes outright).

Prescription charges up to a limit of €10/month were introduced for medical card holders; this will impact particularly on older people, especially those with chronic illnesses. The carbon tax will impact disproportionately[7] on older people since pensioners spend more time at home and require more heating. Although, in his Budget Speech, Minister Lenihan promised a 'vouched fuel allowance scheme' to offset the impact of the carbon tax on low-income groups, no further details have been forthcoming. The ESRI has concluded that a carbon tax will be regressive unless tax revenues are used to increase social benefits and tax credits.

[5] At risk of poverty rate identifies the proportion of individuals who are considered to be in danger of poverty, based on the level of their income and taking into account their household composition. It is calculated as the percentage of persons with an equivalised disposable income of less than 60% of the national median income.

[6] CSO (2009) *Survey on Income and Living (SILC) 2008*.

[7] See also Callan, T., Lyons, S, Scott,s., Tol, R., *The Distributional Implications of a Carbon Tax in Ireland*, ESRI 2008

TASC Pension Model

The TASC pension model is based on two tiers.The first tier involves universalising the social welfare pension to provide a guaranteed income for all older people, which would virtually eliminate pensioner poverty. The second tier is based on the social insurance system, and would provide an earnings-related pension allowing people to save for retirement while removing the risk and uncertainty associated with private pension provision.

The TASC pensions policy is being updated in the context of the seismic changes that have taken place in the financial markets, economies and banking systems across the world. In particular, the turmoil in the financial markets clearly highlights the inadequacy of Ireland's pension system. Private pension provision is a central tenet of Irish pensions policy. However, Ireland's private pension funds have been heavily hit by the financial crisis, with real losses of 37.5 per cent in 2008. According to the OECD (2009), this is the worst investment performance for private pensions in the 30 OECD countries. The performance of private pension funds have experienced a recovery in the latter part of 2009, with the value of managed pension funds increasing by 21.8% in 2009. Nevertheless, they still have a long way to go before recovering the losses of recent years.

Recent events clearly demonstrate the vulnerability of the current system of pension provision to external factors. It is fundamentally flawed and requires radical reform as it is costly, the returns are uncertain and it is highly inequitable.

Financial regulation and protection of pensions

The crisis in the financial markets and the ensuing economic crisis have demonstrated a range of shortcomings in a pensions policy that relies heavily on privately funded equity-based pension investments to provide a large proportion of income for older people. TASC advocates the phased introduction of a State-led pension system. However, there are serious problems faced by current members of occupational pension schemes that will need to be addressed in the short term. Many of the current problems with pensions have their origins in the inadequacy of financial regulation, with regulations not being strong enough or effectively enforced. There is also the issue of pension funds in deficit and the need to protect occupational pension funds when companies get into financial difficulties or when they go into liquidation[8].

[8] The TASC pension model makes a number of specific recommendations in relation to pension fund deficits and pension fund protection in Part II.

The huge losses in Irish pension funds were a direct result of aggressive investment return assumptions that took insufficient account of investment risks and downsides. The Pensions Board raised these concerns in its 2006 and 2008 Annual Reports, and made a number of recommendations relating to the provision of clear explanations of investment choices and risks, as well as the availability of lower risk investment options to members.

However, in other OECD countries, pension funds are governed by regulations that include the application of quantitative restrictions such as setting minimum levels of investment in secure Government bonds and deposits and maximum limits in higher risk investments. For example in Denmark, pension funds must invest a minimum of 60 per cent of their portfolios in Government bonds and a maximum of 40 per cent in equities[9]. Ireland has no such quantitative restrictions in place. Irish pension funds lost (-37.5 per cent) over twice as much as Danish pension fund (-16.8 per cent) in 2008[10].

There is a clear need for stronger financial regulation. The *Report of the Special Group on Public Service Numbers and Expenditure Programmes* (2009) has recommended that the Pensions Board be amalgamated with the Financial Regulator. TASC agrees that there is a need for stronger financial regulation, with the regulator imposing more stringent requirements on pension providers in relation to managing risk, setting maximum charges and eliminating practices such as pension providers charging the same amount in fees regardless of whether the fund makes money or not.

Standard-rating tax relief on private pension contributions

Tax relief given against private pension contributions is a very significant tax expenditure (€3bn per annum). The OECD noted in its 2008 *Economic Survey of Ireland* that many pensions are unlikely to be fully taxed at any point in the lifecycle, which means that the Exchequer never fully recoups the revenue forgone through tax relief on pension contributions. Also, 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 also performs badly in terms of equality, since 80 per cent of these reliefs go to the top 20 per cent of earners[11].

[9] OECD *Survey of Investment Regulation of Pension Fund* www.oecd.org/dataoecd/30/34/2401405.pdf

[10] OECD 2009, *Pensions at a Glance.*

[11] ESRI (2009), *Pensions Policy: New Evidence on Key Issues.*

There are a number of recommendations calling for the reduction in tax reliefs for private pension contributions. The OECD and Commission on Taxation have recommended that reduced levels of tax relief should be accompanied by a better targeting of subsidies at lower and middle income earners. The Commission on Taxation specifically recommends standard-rating tax relief at 38 per cent in the short term, but also proposes that all tax reliefs be replaced by a 'SSIA style' matching Exchequer contribution in the medium to long term.

The Government has indicated that it is considering standard-rating tax relief on pensions at 33 per cent[12] as part of the Government's National Pensions Framework, which is due for publication shortly. The ESRI (2009) quantified the savings that could be made by standard-rating tax relief at the standard rate of income tax (20 per cent). It estimated that savings of €1bn could be made, with 80 per cent of this revenue coming from the richest 20 per cent of earners. The ESRI also suggests that revenue raised could be applied to sustaining State pension levels as demographic pressures on the financing of public pensions intensifies in the coming years.

The ESRI proposals come closest to TASC's recommendation that the revenue raised by cutting tax reliefs would make a significant contribution to funding a universal pension system and guaranteed income for all older people. Reducing tax relief should be used to fund the transition towards a universal guaranteed income[13] for older people, whereby savings made through cutting tax reliefs are diverted into State pension provision.

Role of social insurance in State-led pension provision

The second tier of TASC's pension model is based on the social insurance system, which would provide an earnings-related pension that allows people to save for retirement while removing the risk and uncertainty associated with private pension provision. The Minister for Finance, in his Budget 2010 speech, stated that pension costs are set to increase as life expectancy improves and the population ages. Changing demographics, as well as the impact of the financial and economic crises, provide a clear rationale for pension reform and investment in social security as a means to providing cost-effective State-led pension provision.

[12] The Minister for Social and Family Affairs indicated that there would be "... *a 4 year lead in period before major changes such as a consolidated tax relief rate of 33%.*

[13] TASC defines an adequate universal guaranteed income as being 40% of average industrial wage.

The Minister also indicated in his speech[14] that he intends to integrate the tax and social welfare systems, and to introduce a new system in 2011 comprising just two charges on income.

- A new universal 'Social Contribution' will replace employee PRSI, the Health Levy and the Income Levy. It will be paid by everyone at a low rate on a wide base as a collective contribution to public services.
- Income tax will apply on a progressive basis to those with higher incomes, reflecting their capacity to make a greater contribution.

These proposed changes create the opportunity to develop the infrastructure needed to establish a Social Insurance (Retirement) Fund that could be used to provide an earnings-related pension. There are no further details available on the proposed integration of the tax and welfare systems, but it is worth putting Ireland in the context of its European counterparts in this regard.

Social protection[15] expenditure in the EU-27 represented 27.2 per cent of GDP[16]. In Ireland, expenditure in social protection represented 18.2 per cent of GDP, which was significantly lower than the European average. Our European counterparts have substantially higher levels of investment in social protection because they use the social protection system not only to provide a range of supports to their populations, but also to address demographic issues (i.e. increasing dependency ratios) to provide an adequate income to an aging population.

[14] Department of Finance, *Financial Statement of the Minister for Finance Mr. Brian Lenihan, T.D.*, 9th December 2009. http://www.budget.gov.ie/Budgets/2010/FinancialStatement.aspx
[15] Social protection systems are designed to protect people against the risks associated with unemployment, parental responsibilities, ill health and invalidity, the loss of a spouse or parent, old age, housing and social exclusion.
[16]2005 provides the latest comparable data at EU level and is reported by Eurostat in *Europe in figures - Eurostat yearbook 2009.*

Part II

THE TASC PENSIONS MODEL

Universal Equitable Affordable Secure

Ireland currently operates a mixed pension system, comprising both public (Social Welfare) and private elements. Yet, despite the fact that most pensioners rely on the Social Welfare system for an income, the Exchequer spends almost as much on subsidising private pensions (through tax reliefs) as it does on funding public pensions: €4.3bn on State Pension[17] and €3bn on tax reliefs[18]. And the overwhelming majority of those tax subsidies go to the highest income groups. Eighty per cent of tax relief went to the top 20 per cent of earners (ESRI, 2009). In some cases, these tax breaks subsidise tax shelters … rather than pensions.

Ironically, the shortcomings of our public pension system are, in large part, due to the tax subsidies flowing into the private pension system.

TASC believes there is another way. Our proposals are designed to benefit all current and future pensioners, to remove the inequities which presently impact on women and atypical workers - and to reduce the cost to the Exchequer (which, ultimately, means the cost to us – the taxpayers).

The First Tier: Increasing the State Pension ….

During recent years, Social Welfare pensions have slowly risen relative to average earnings and are now at a stage where it would be possible to increase them to a level that would virtually eliminate pensioner

[17] Department of Social and Family Affairs (2009) *2008 Statistical Information on Social Welfare Services.*

[18] Letter dated 11 September 2009 from Secretary General Department of Finance to Clerk of Committee of Public Accounts.

poverty. However, this progress was halted in Budget 2010, and there is a real risk that Social Welfare pensions will now start to fall relative to average earnings. TASC proposes significantly **increasing** the Social Welfare pension to 40 per cent of gross average industrial earnings over a five-year period.

Universal

... and Universalising it to provide a Guaranteed Income for Older People

Simply increasing the Social Welfare pension would not resolve the complications arising from incomplete contribution records, means tests, dependency rules and the retirement condition required for the State Pension (Transition). Nor would it address the interaction of Social Welfare pensions with private pensions, which creates uncertainty about how much to save and results in the loss of private pension benefits for low-paid members of some occupational Defined Benefit pension schemes.

In particular, it would do little to address the problems faced by women, who are particularly disadvantaged by both the State and private pension systems because they provide most of the care required by children and elderly relatives. This means their work histories are more irregular than those of men, and it is more difficult for women to qualify for either a State or a private pension. This is one of the reasons why women are disproportionately vulnerable to poverty in old age.

This is why TASC proposes **universalising** the (increased) Social Welfare pension, transforming it into a **guaranteed income** available to all long-term residents of Ireland on reaching the age of 65.

The Second Tier: A Social Insurance Pension

An increased and universal State Pension would meet the first goal of any progressive pension reform: **poverty prevention**. But it would not meet the second goal: ensuring that all pensioners can enjoy a **comfortable and independent life** in retirement. To meet that goal, TASC proposes transforming the existing flat-rate social insurance

pension into a **second-tier** social insurance pension based on contributions. This would still allow people to save for retirement, but would remove the risk and uncertainty associated with the various forms of private pension provision.

The second tier would be phased in over a ten-year period, and we propose that it be inaugurated simultaneously with the introduction of the proposed new Universal Social Contribution system in 2011. The second tier would be:

- established as a new **Social Insurance (Retirement) Fund**, administered independently of Central Government;
- **mandatory** for all employed and self-employed; and
- a **Defined Benefit** scheme, so that together with the universal pension, contributors would be guaranteed 50 per cent of their final wage or salary up to a specified maximum[19].

It would be funded by:

- mandatory earnings-related **equal** contributions paid by the employee, the employer and the State (to compensate for having no employer, the self-employed would pay an increased levy).

While the Social Insurance pension would primarily be related to income, contribution credits would be awarded for periods spent on family duties (such as **childcare** and **eldercare**) or in **further education**, and would also be paid during periods of **unemployment** or **disability**. This would be of particular but not exclusive benefit to **women**.

We believe that this second-tier proposal would be of particular benefit to middle-income earners, who at present are exposed to a private pensions market characterised by high fund management charges and high levels of risk and uncertainty.

[19] The transition towards implementing the income guarantee would have to take into consideration other pension arrangements that may be providing some older people with an income of 50 per cent of their final salary .

Equitable

TASC believes that a (social) insurance-based pension supplement is **equitable** since it not only **transfers the risk** from the individual to society as a whole, but also – by incorporating contribution credits – recognises the needs of **individuals**, rather than simply of workers.

Rebalancing from Private to Public: Reducing Tax Reliefs

When we think of State expenditure on pensions, we normally think of the cost of Social Welfare pensions. But there is a range of tax reliefs designed to increase private pension take-up. And by 2007 those tax reliefs – or Exchequer giveaways – amounted to 9 per cent more than the cost of social insurance pensions ... and over three times the cost of means-tested pensions.

TASC believes that the cost of these tax reliefs – which disproportionately benefit the wealthiest in society – represents an untapped resource. And we believe that resource should be used to fund reforms which will benefit **all** current and future pensioners.

Affordable

For example, increasing the State Pension to around 40 per cent of average earnings - which would have a transformative impact on the living standards of older people – would **cost less than half the tax reliefs on private pension contributions**.

That is why TASC proposes **standard-rating all pension-related tax reliefs at 20 per cent, and reducing to €75,000 the ceiling on earnings** which may be taken into account for contribution tax relief purposes. TASC does not believe that increasing the rate at which lower paid workers can claim relief to 33 per cent will significantly increase pension coverage, and therefore will fail on its own terms.

Secure

As well as providing financial **security** for **today's pensioners**, TASC proposals would **remove uncertainty** from pension planning. Rather than depending on the skill (or otherwise) of fund managers playing the equity market game - a game with uncertain outcomes – **tomorrow's pensioners** would not only know that they are **guaranteed** 50 per cent of their final wage upon retirement: they would also know that that guarantee is backed by the State.

While TASC advocates the phased establishment of a new State-led pension model, we are also conscious of the problems faced by current members of occupational pension schemes. Former workers at Waterford Glass and SR Technics – to name just two enterprises – are today paying the price for Ireland's continuing failure to implement the 2003 EU Insolvency Directive. **The Pension Insolvency Payment Scheme in 2009 will have an ameliorative effect, but it is no substitute for a comprehensive pension protection system.**

TASC believes such a system is required to ensure that employers meet their obligations to fully fund Defined Benefit Schemes and to ensure that pension funds are protected in the future. TASC proposes that the **Companies Acts be amended to ensure companies continue contributing to Defined Benefit schemes** which are in deficit, rather than paying dividends to shareholders.

TASC also argues that **pension benefit guarantee schemes are required** for both Defined Benefit and Defined Contribution schemes. We note that pension protection schemes are being run successfully in other OECD countries such as Germany[20]. Ireland can, therefore, learn from their experience of how to avoid the pitfalls of moral hazard and adverse selection to which pension protection schemes are prone.

The financial crisis has clearly demonstrated serious deficiencies in the area of financial regulation, and in this context TASC recommends the **stronger financial regulation,** with the regulator imposing more stringent requirements on private pension providers in relation to managing risk and fund administration charges.

[20] Stewart, F. (2007), "Benefit Security Pension Fund Guarantee Schemes", *OECD Working Papers on Insurance and Private Pensions,* No. 5, OECD.

Ultimately, of course, reform of our pension system is a political issue, and its resolution depends on the answers to a number of key questions.

Do we believe that the individual should – through private pensions, and all the risks and uncertainties they entail – bear sole responsibility for ensuring a decent income in retirement? Do we believe that the stock market – with its ups and downs, its bubbles and busts – can provide for something as essential as a secure retirement? Or do we believe that fundamental risks such as those inherent in ageing should be spread across society in the form of social insurance – not merely because we all share in those risks but because, by pooling our resources, we can offer a more efficient and equitable solution to future pension provision?

Can we afford these reforms? Yes. In fact, we cannot afford not to reform our pension system. We have already shown that tax reliefs – which benefit a minority – have mushroomed to the point where they are set to outstrip expenditure on the public pension system. The question is not about how much we spend – but how effectively and equitably we spend it.